18

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

MARCH 9, 10, 16, 17, 23, 31; AND APRIL 1, 1993

PART 2 OF 2

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CONTENTS

WITNESSES

SUBMISSIONS FOR THE RECORD

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

TUESDAY, MARCH 23, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Michael A. Andrews presiding.

Mr. ANDREWS. I would like to call the hearing to order, please, and ask our first panel members to please take their seats.

Good morning. Today, we are continuing our series of hearings on President Clinton's economic and deficit reduction plan.

First, we will hear from three panels, each consisting of representatives of taxpayers who would be affected by the administration's proposed energy tax. We look forward to hearing about the potential impact of that broad-based tax on consumers, producers, marketers, transporters, and regulators.

In addition, we will hear from representatives of local governments and organizations that are interested in housing and economic development. We expect these witnesses to testify on the President's proposals with respect to low-income housing, mortgage revenue bonds, enterprise zones, and other measures providing relief to our Nation's distressed communities.

Finally, we will hear from a panel representing State housing agencies and the real estate and mortgage banking industries. These witnesses are expected to testify regarding provisions in President Clinton's proposal that would affect housing and real estate, such as the provisions relating to the low-income housing tax credit, passive loss rules, and pension investments.

I would like to suggest to my friends from the producing States who are here to testify today not to misread anything into the fact that Congressman Archer and I are in charge. I wish it were true.

I would now like to welcome our first panel to the committee. If each of you, please, as we go from my left to my right, would introduce yourself and state who you represent, so that your testimony may be made a part of the record, and please, if possible, narrate your testimony. Please give us your thoughts and then we will open the panel for questions.

First, Mr. Archer, did you have a statement you wanted to make?

Mr. ARCHER. Mr. Chairman, thank you very much. I just want to welcome the gentlemen here before the committee, and we look forward to your testimony today.

Mr. ANDREWS. Would any other member of the committee like to make an opening statement?

Mr. Mitchell, we will proceed with you.

STATEMENT OF EDWARD F. MITCHELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, POTOMAC ELECTRIC POWER CO., WASHINGTON, DC, AND CHAIRMAN, EDISON ELECTRIC INSTITUTE

Mr. MITCHELL. My name is Edward F. Mitchell. I am chairman and CEO of the Potomac Electric Power Co. and here today representing the Edison Electric Institute as chairman of that organization.

Thank you very much, Mr. Chairman, for the opportunity to present some concerns to you. We have also had the opportunity, and greatly appreciate it, to meet with the administration in various departments and we appreciate the opportunity to talk with them. We have no idea what the outcome of that is as of the current time, of course.

What I want to do is focus on the Btu energy tax and touch on the corporate tax increase, the investment tax credit and the proposed changes to the alternative minimum tax.

Let me begin by saying that our organization is strongly supportive of the Congress and of the administration in trying to find some way to reduce the deficit and to put a little boom into the economy. We are strongly supportive of every activity there, and many of the President's proposals will help reach those goals.

We would suggest to you, however, that the proposed energy tax will not stimulate the economy and should be rejected. We do have an alternative tax proposal to suggest to the committee.

We are very concerned that the Btu energy tax is going to have a much greater negative effect on our Nation's economy than has been projected. We ask you to carefully weigh the fact that low cost and reliable energy is a fundamental ingredient of our economy. It has been responsible for our economic well-being for decades and will in the future.

President Clinton's proposed energy tax, if enacted, will result in a substantial increase in the price of energy over time and will turn what has been an economic strength into a weakness. For example, for PEPCO, the proposed Btu energy tax, when it becomes fully effective, will result in an annual tax increase of over $76 million.

If you then figure in the piggyback tax effects, and this is one thing that everyone has to understand, that the gross receipts tax will go in on top of the energy tax as it is currently proposed, that would increase our $76 million tax increase to $80 million. That is, in one fell swoop, a 30-percent increase in our tax base. Our tax load. Our payment to the Government in taxes. That does not include the impact of the change in the corporate income tax rate.

Although well-intentioned, we would suggest to you that the energy tax will increase the price of every U.S.-produced good in this country and service and will end up making our Nation less competitive in the world market.

The whole purpose of the proposal is to strengthen the economy, create jobs, and it is quite likely the energy tax will do somewhat the opposite from what everyone would expect it to do.

Since the Btu energy tax will increase the price of energy consumed in the United States and, therefore, increase the price of every domestically-produced product, it will surely harm us on the global market. It is a tax on production, and the direct and indirect effects of the tax will increase the price of everything produced in the country and do nothing on the imports coming in from the global marketplace.

So, ironically, what we are doing with this process is not only making us less competitive but, in effect, we are providing a subsidy for foreign imports. We would suggest that that is of significant concern to us and to this committee.

If you look at our large industrial customers, which will be the most significantly affected, they will bear the greatest percentage increase. In some regions of the country those increases will exceed 10 percent. That is going to be very, very difficult. Many of the basic industries, those which drives our whole economy, such as, steel, aluminum, chemical, paper, agriculture, airlines, which consume large amounts of energy, will be adversely impacted by the implementation of this tax.

So at the time when our industries really should be focusing on productivity gains, we are, instead, going to have to be focusing on diverting all of our energy and resources to handle the Btu energy tax.

If a new energy tax is required, we believe the administration and the Congress should seriously consider and evaluate a broad-based consumption tax which can be imposed in compliance with the GATT trade rules on imported goods and remove from U.S. exports in order to maintain our competitive position in the world marketplace. If we don't do that, we are at a huge disadvantage and will remain so.

A broad-based consumption tax can be designed to be less regressive. It could also help to resolve both our budget deficit and our health care concerns, which will be shortly upon us in the legislative arena. Although no one really wants to consider a new tax, before we adopt the proposed energy tax which will really hurt the economy, and hurt U.S. jobs, we need to seriously consider the alternatives.

With respect to the proposed increase in the corporate income tax, I was a little shocked to hear the proposal was going to be made retroactive. For a regulated industry that, of course, means that whatever has been done for that retroactive period, you are hereby forevermore excluded from recovering that as a cost. That is literally impossible to do. No commission will allow retroactive recovery of costs throughout this Nation.

So any corporate tax increase, we would suggest to you, should have an effective date which takes into account a regulatory delay which could be anywhere from 9 to 18 months. If, however, the commission or the committee feels that a faster action is required, that time can be shortened but it will still have the same ultimate end result.

We do support the President's efforts to reenact the investment tax credit. We would suggest to you, however, that the proposed incremental rate, the ITC, really punishes organizations which are heavily capital intensive. That is built in to the system. It would be much better if the ITC were to be a broader based, an overall investment, not just incremental.

Incremental is going counter to what the Congress has tried to do with the passage of the Energy Act, for example, to create a competitive market. But then putting into place something that clearly penalizes the utility and favors someone who did not actually build a power plant, let's say several years ago, or in the base year, that is a great inequity that really should be dealt with.

The President's alternative minimum tax proposal, we believe, is good, and it will surely lessen the somewhat onerous impact of the AMT on capital-intensive industries that we have had in recent years.

In conclusion, we would suggest to you the best way to reduce the deficit is, of course, as I am sure all of you support, to reduce and control spending. However, if a tax increase is needed, then we encourage you to fairly evaluate a broad-based consumption tax. The proposed Btu energy tax is unwise economic, environmental and energy policy. It would seriously damage the economic recovery and will hurt the United States on the international market.

If it is the will of the Congress to put the proposed Btu energy tax in effect, we would strongly urge that the imposition of that tax be in the form of an excise tax. This will minimize the cost of the piggyback tax that I talked about before and will help protect our customers.

That, basically, is what we are after here. We are concerned—we don't pay taxes ultimately in the long run. The consumers of the United States, the ratepayers, pay the taxes, and our concern is in that arena now.

So we appreciate the opportunity to appear this morning, Mr. Chairman, and we will try to deal with any questions that the committee might have. Thank you.

Mr. ANDREWS. Thank you, Mr. Mitchell.

[The prepared statement follows:]

**STATEMENT
OF THE
EDISON ELECTRIC INSTITUTE
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES**

Mr. Chairman and Members of the Committee:

I am Edward F. Mitchell, Chairman of the Board and Chief Executive Officer of Potomac Electric Power Company. I appreciate the opportunity to appear today representing the Edison Electric Institute (EEI), as its current Chairman, to present our views on President Clinton's proposals for public investment and deficit reduction.

EEI is the association of electric utility companies. Our members serve 99 percent of all customers served by the investor-owned segment of the industry. We generate approximately 78 percent of all electricity in the country and provide electric service to 76 percent of all ultimate electricity customers in the Nation[1].

EEI strongly supports the efforts of the President and the Congress to reduce the federal budget deficit and to promote a strong economic recovery. The difficult issues to be decided involve how much and which spending reductions and tax increases, if any, are needed in order to strengthen the growth in the economy and to reduce the deficit.

EEI strongly advocates sound economic, environmental, and energy policies. These policies should be developed so that they are in consonance with one another. Congress enacted new and strengthened environmental and energy statutes in 1990 and 1992. The proposed Btu energy tax must be examined in light of the cost of these new laws and the effect they will have on our Nation's economy. We believe the net effect of the proposed Btu energy tax will result in unsound economic, environmental and energy policy.

Our testimony today focuses on the President's revenue proposals, including the Btu energy tax, the corporate tax rate increase, as well as the incremental investment tax credit and the depreciation changes in the alternative minimum tax. Each of these proposals is discussed below.

Btu Energy Tax

EEI believes the proposed Btu energy tax has serious economic, environmental and energy policy implications, each of which are outlined below and discussed in detail thereafter.

- Economic Impact
  - International Competitiveness
  - Customer Effects
  - Regional Disparities
- Environmental and Energy Policy
- Implementation Concerns
- Btu Energy Tax Summary

Economic Impact

The U.S. economy is the strongest economy in the world, and worker productivity is higher than in any other nation.[2] Against this

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[1] Edison Electric Institute (1992). Statistical Yearbook of the Electric Utility Industry/1991. (Washington, DC: Edison Electric Institute), p.1.

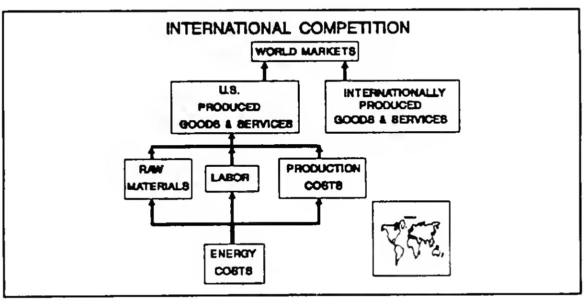
[2] The Washington Post (November 22, 1992). Challenging Convention on Productivity. (Washington, DC).

background, new taxes can have unintended and undesirable economic impacts. Careful consideration therefore must be given to the economic implications of any new tax. A Btu energy tax reduces economic growth, causes jobs to be lost and increases inflation. Since a large tax increase would be imposed on a narrow base (energy expenditures account for only about 8 percent of the gross domestic product (GDP))[3], its negative impact is greater than other possible revenue raising choices.

The harmful impact of the Btu energy tax on the Nation's GDP is confirmed by a recent study conducted by the National Association of Manufacturers. This study estimated that the proposed Btu energy tax could reduce GDP by more than one-half percent in 1996, 1997 and 1998 and reduce employment by more than 600,000 jobs, when the Btu energy tax is fully phased in[4]. Other studies have shown lower job losses, depending upon the effectiveness of monetary policy to accommodate the tax changes. In our view, while the magnitude of the impact may be in question, the direction is not. A Btu energy tax will harm the economy.

International Competitiveness

Since the Btu energy tax will increase the price of energy consumed in the U.S. and therefore increase the prices of all domestically produced goods and services, it will harm our Nation's international competitiveness. The Btu energy tax is a tax on production; therefore, the direct and indirect effects of the tax will increase the cost of all goods and services produced in the U.S., thereby exacerbating the trade deficit as foreign goods displace U.S. goods in domestic and world markets.



Ironically, the proposed Btu energy tax will act as a subsidy for foreign imports since these goods will be exempt from this tax. EEI is very concerned about the effect of this tax on U.S. exports and the exemption the proposed Btu energy tax provides for foreign imports as highlighted by the following chart.

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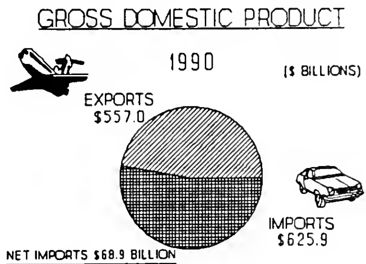
[3] Energy Information Administration. Annual Energy Review 1991. (Washington DC: Energy Information Administration/Department of Energy), p.73.

[4] National Association of Manufacturers (February 24, 1993). Testimony of Jerry J. Jasinowski, President, National Association of Manufacturers, On the Comparative Merits of the Administration's Energy Tax Proposal and a Broad-Based National Consumption Tax, Before the Committee on Energy and Natural Resources, United States Senate. (Washington, DC), p.15.



Source: DRI/McGraw-Hill U.S. Review, February 1993

Although several of our largest trading partners in Europe and the Pacific Rim may have higher gasoline taxes, they have generally rejected other unilateral broad-based energy taxes as too harmful to their domestic economies and international competitiveness[5]. So should we.

Customer Effects

The burden of the Btu energy tax will fall unevenly across income classes, industries and regions of the economy. It is estimated that 27 percent of the additional revenue raised by the Administration's entire tax package will fall on energy consumers[6]. A recent Wall Street Journal/NBC News poll, found that 35 percent of Americans support the energy tax, while 62 percent oppose it.[7] EEI has estimated the percentage cost increases on electricity for each of our customer groups resulting from the proposed Btu energy tax. The Btu energy tax will cause the average price of electricity for our customer groups to increase as follows:

	Overall	Residential	Commercial	Industrial
Percent Increase[8]	4.2%	3.5%	3.8%	5.9%

***Note:** These percentage increases in the cost of electricity reflect the fully phased in Btu energy tax rates but do not include the additional cost effects of piggyback taxes and the increased corporate tax rate.*

Our large industrial customers will be significantly affected. These customers bear the greatest percentage increase in their cost of energy of all customer classes from the proposed Btu energy tax. In some regions of the Nation, the increase in the cost of electricity will exceed 10 percent for industrial consumers.[9] With such price increases, there will be regional and industry dislocations along with associated job losses. Basic industries, such as steel, aluminum, chemical, paper, agriculture and airlines, which consume large amounts of energy, will be significantly and

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[5] IEA Coal Research (August 1990). Market Mechanisms for Pollution Control: Impacts for the Coal Industry. (Washington, DC).

[6] President Clinton's Revenue Provisions.

[7] The Wall Street Journal (March 11, 1993). Clinton, Seeking Help for Economic Plan, Mulls Energy-Tax Break on Ethanol, Some Natural Gas. (Washington, DC).

[8] Edison Electric Institute (1993). EEI Summary of President Clinton's Btu Energy Tax Proposal. (Washington, DC).

[9] Edison Electric Institute (1993). Company Estimate of Btu Energy Tax. (Washington, DC).

adversely affected by energy taxes. At a time when industries need to concentrate resources on productivity improvements, resources would be diverted to pay for a Btu energy tax.

In addition, included in the Administration's Btu energy tax proposal is a provision that calls for the Btu energy tax rates to be indexed to inflation after 1997, which would worsen the inflationary effects and the regional disparities inherent in the proposed Btu energy tax. Further, the indexing provision would cause an inflationary spiral with Btu energy taxes contributing to higher inflation and higher inflation contributing to even higher Btu energy tax rates. Regional disparities would also increase under the tax since regions with slower economic growth would be subject to increased Btu energy taxes indexed to the national rate of inflation, even though these regions' price increases would be held to lower than average levels because of reduced demand.

A tax on an essential service such as electricity would be especially regressive for residential consumers. This tax is not based on the ability to pay. The proposed Btu energy tax is a major tax increase on low and moderate-income households and senior citizens. These households spend a greater proportion of their income on energy needs and generally are financially unable to pay for additional measures to conserve energy. A recent study by the Environmental Protection Agency found that consumers in the bottom 20 percent of incomes spend 7.5 percent of their incomes on energy consumption versus those consumers in the top 20 percent of incomes, who spend only 4.7 percent.[10] Similarly, this tax will fall on the elderly and others on fixed-incomes at a time when lower investment earnings and skyrocketing health care costs already are decreasing their standard of living. This is the worst type of regressive tax in that it is placed on a necessity. Unlike a tax on discretionary spending, this tax falls directly on essential services such as home heating and lighting.

We applaud the Administration's desire to counter the regressiveness of the proposed Btu energy tax. However, we believe that the measures proposed by the Administration such as increased funding for LIHEAP (Low Income Home Energy Assistance Program), the Earned Income Tax Credit, food stamps and weatherization programs will not counter, to the extent necessary, the regressive nature of the proposed Btu energy tax.

<u>Regional Disparities</u>
As mentioned earlier, a Btu energy tax will result in regional disparities, and its impact will vary across different states of the country. Our studies indicate, as displayed in the chart on Page 5, a significant regional disparity among the 25 largest energy consuming states resulting from the fully phased in Btu energy tax.

Environmental and Energy Policy

The Administration has said that the main goals of the Btu energy tax are to promote energy conservation, encourage energy efficiency, reduce pollution and reduce the deficit. However, the costs of an energy tax are unlikely to lead to any meaningful environmental benefits. The imposition of energy taxes increases the likelihood that production activities which are negatively affected will seek locations elsewhere in the world where environmental regulations are less stringent and costly. Thus, over time, global emissions may actually rise.

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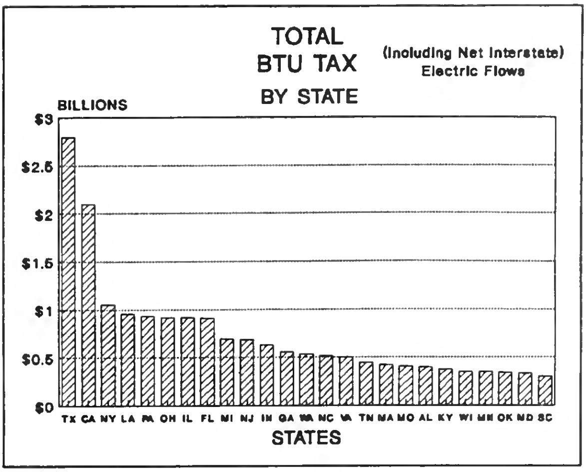
[10] Energy Policy Branch, <u>The Distributional Impacts of a Carbon Tax.</u> U.S. Environmental Protection Agency (May 27, 1992). Washington DC, p.8.



Source: State Energy Data Report 1960-1990. Table 4, p.21

Substantial environmental improvements are already being achieved and will continue to be achieved under existing U.S. laws and regulations without the necessity of a Btu energy tax. Between 1970 and 1989, air pollution declined significantly: particulates fell 61%, sulfur dioxide 26%, carbon monoxide 40% and volatile organic compounds 31%.[11] In 1972, the Nation spent about $17 billion on pollution abatement and control.[12] By 1990, these expenditures had risen to $90 billion according to the U.S. Department of Commerce.[13]

Moreover, energy is already substantially "taxed" because of the costs of compliance with environmental regulations. For instance, electric utilities spend billions of dollars each year to comply with numerous environmental statutes. The Clean Air Act Amendments of 1990 are expected to add $3 to $4 billion to consumer electric bills annually.[14]

The recently enacted Clean Air Act Amendments of 1990 and the Energy Policy Act of 1992 both included significant provisions to encourage conservation and for protection of the environment. Neither of these Acts has yet been fully implemented. The Clean Air Act Amendments, when fully implemented, are estimated to cost the U.S. economy at least $21 billion annually[15]. It makes sense to allow these provisions to be fully implemented and to review their benefits to the environment before increasing costs further on the energy sector of the economy.

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[11] Council of Economic Advisors (January 1983). Economic Report of the President. (Washington, DC), p. 231.

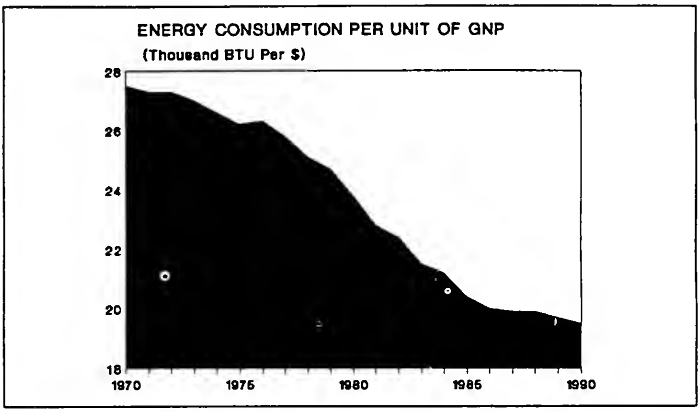
[12] Bureau of Economic Analysis, U.S. Department of Commerce. Survey of Current Business. (Washington, DC), p.35.

[13] Ibid., p.36.

[14] Office of Air and Radiation, Environmental Protection Agency (November 15, 1992). Implementing the 1990 Clean Air Act: The First Two Years. (Washington, DC), p.39.

[15] Ibid, p.17.

The Energy Policy Act of 1992 set out an energy policy designed to meet future energy requirements for the Nation. Among other provisions, this legislation encouraged increased emphasis on conservation and alternative energy resources. Energy efficiency programs in existence before this legislation represented a significant dedication of resources on the part of electric utilities toward conservation goals. For example, in excess of $2 billion was spent by the industry for energy efficiency programs in 1992[16]. The programs already in existence and those yet to be developed in accordance with the Energy Policy Act will be far more constructive than a Btu energy tax in achieving energy efficiency goals. Our industry currently has over 2,000 various energy efficiency programs in place and none of these programs includes a tax increase on our customers[17]. It is important to emphasize that America consumes substantially less energy per unit of GNP in 1990 than it has over the prior twenty years as is highlighted by the chart below.



Source: Arthur Andersen/Cambridge Energy Research Associates. Table 2, p.57.

One reason for expected gains in energy efficiency along with continued growth in the use of electric power is that electricity is a more efficient and environmentally sensitive energy source in many applications where it is replacing direct fuel combustion at the point of end use. This continuing growth in electricity is highlighted in the chart on the next page.

Electricity is also being used in high-tech applications that lack alternative power sources, e.g. computers and automation. The future is one in which the combination of improving energy efficiency and greater electrification will continue. Examples of the use of electrotechnologies that are more efficient than technologies using other fuels include: electric arc furnaces, induction heating, microwave drying, plasma-fired technology, and freeze concentration in the chemical, food, glass, paper, timber and petroleum industries.

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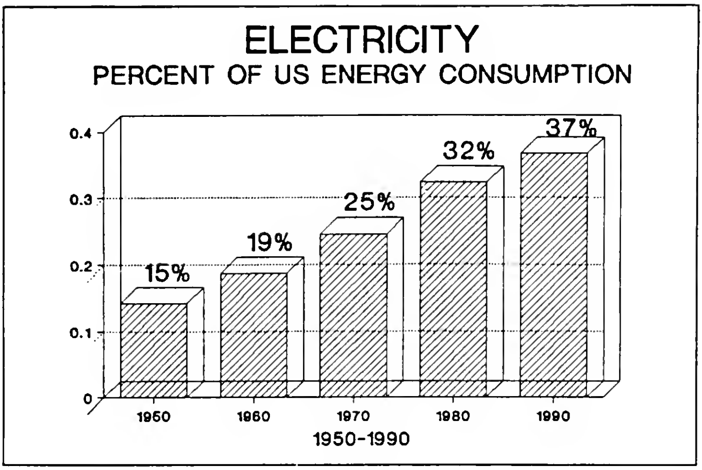
[16] Barakat & Chamberlin, Inc., and EPRI (December 1992). Impact of the Electric Utility Sponsored DSM Programs on Future Customer Electricity Demand. EPRI Research Project 2863-8. 3rd Ed., (Palo Alto, California), p.ES-17.

[17] Plexis Research, Inc. for EPRI. (January 1993) SURIS: DSM Survey Information System. (Donegal, PA), p.1.



Source: Energy Information Administration, Annual Energy Review 1991. Table 5, p.15.

The electric utility industry has supported efforts to establish sound energy policies, e.g., the policy of domestic self-reliance. During 1991, approximately 55 percent of the electricity produced by the industry was generated from coal, 22 percent from nuclear, 10 percent from hydro, 9 percent from natural gas, 4 percent from oil, and less than one percent from other sources, such as solar, wind, wood, waste and geothermal.[18] The industry's fuel mix has changed since the 1970's, when the oil embargo caused the industry to reduce its reliance on oil in the production of electricity from 16 percent to 4 percent currently[19]. The New York Times singled out the electric utility industry as responding positively to the energy crisis of the 1970s.[20] As a Nation, we should be encouraging the use of electricity for environmental, energy and economic policy reasons, not discouraging it with the proposed Btu energy tax.

Implementation Concerns

The electric industry is comprised of the investor-owned segment, the rural electric cooperative segment, the government-owned (federal, state and local government) segments and non-utility generators, including self-generators. The proposed Btu energy tax, if enacted, should subject all segments of the electric utility industry to the proposed Btu energy tax in order to ensure competitive balance.

If the proposed Btu energy tax is enacted, serious problems would have to be resolved which include a clarification of the tax base. Such legislation should clearly state that such tax is imposed on the fuel Btu content or the imputed fuel Btu content of all energy sources. If the proposed Btu energy tax is enacted, with the tax

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[18] Edison Electric Institute (1992). Statistical Yearbook of the Electric utility Industry/1991. (Washington, DC), p.29.

[19] Ibid.

[20] The New York Times. (August 25, 1992). Oil? Nation's Utilities Are Not So Worried. (New York).

imposed at the fuel source, then it is anticipated that the resultant increased fuel costs would be recovered from utility customers through regulatory energy fuel clauses, where available.

Conventional wisdom seems to be that the utility will pass the Btu energy tax through to its customers and therefore will not bear the burden of the tax. However, this erroneously assumes instantaneous recovery of the tax cost by the utility. In some jurisdictions, there are moratoria on rate increases, and an additional tax is not likely to be passed through very quickly under such circumstances. Moreover, even in the most responsive jurisdictions, some delay is possible resulting in an adverse impact on utilities.

The current tax burden on electric utilities and their customers, including the federal income tax and state and local taxes is among the highest of any industry. As an example, the electric utility industry has recently borne an average state and local tax rate that is more than twice that imposed on all other business sectors.[21] A large portion of a utility customer's bill is made up of taxes. In many states, 20 percent or more of a customer's electric bill is for taxes either charged directly to the customer or indirectly through the taxes paid by the electric utility. This does not include the taxes built into the price of products and services utilities buy. The proposed Btu energy tax will have a compounding effect when additional taxes, i.e., gross receipts, franchise fees, sales taxes and other utility taxes are automatically increased due to an energy tax imposed on electric utilities. The increase in these "piggyback" tax costs is significant and substantially adds to the cost of the energy tax for electric customers. These piggyback tax costs are a direct result of the way the proposed Btu tax is imposed. Because the Btu energy tax is imposed upon the utility and/or its fuel costs these piggyback taxes will occur. If the Btu energy tax is imposed upon the consumer of electricity, which is consistent with the energy conservation and environmental goals of the Administration, these piggyback tax costs could be avoided for our utility customers.

If the proposed Btu energy tax is implemented, the differing Btu tax rates applied to fuel sources may affect competition among various fuels. For example, certain fuel supply contracts may be indexed to the price of other fuels subject to differing tax rates under the proposed Btu energy tax. Unless such a tax is very precisely imposed, unanticipated distortions of current relationships among energy sources are inevitable. In some cases, if the tax is not implemented properly, electricity could be subject to double taxation, such as the case of pumped storage hydro. These factors, if not taken into account, could have an adverse impact on energy competition.

Btu Energy Tax Summary

In summary, EEI strongly opposes the proposed Btu energy tax because it will be counterproductive in reducing the federal budget deficit and promoting a strong economic recovery. Perhaps a better answer to the federal deficit problem, if revenue needs to be raised, is to consider a broad-based consumption tax. The proposed Btu energy tax may be significantly inferior to a broad-based tax on all consumption. Energy expenditures account for only about 8 percent of the GDP. A Btu energy tax, which by definition is narrowly based, is simply an inequitable way for the government to raise tax revenue by focusing only on energy and U.S. produced goods and services.

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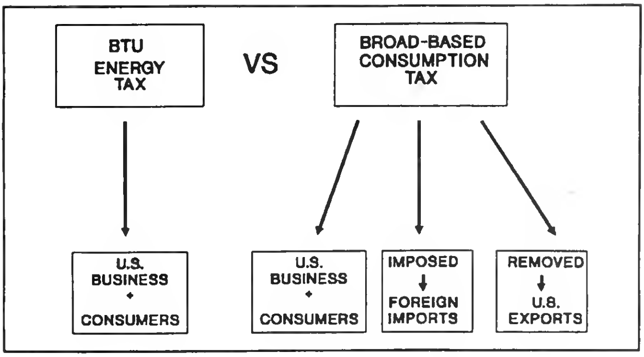
[21] Edison Electric Institute. (1993) Analysis of the Electric Utility Industry 1991 Tax Burden. (Washington, DC).



A broad-based consumption tax could be spread uniformly across the U.S. economy and would not unduly penalize particular businesses or regions of the country. Unlike a Btu energy tax, a broad-based consumption tax will not harm our international competitiveness because it could be border adjustable and as such could be removed from U.S. exports and imposed upon foreign imports. A broad-based consumption tax may also exempt essential goods and services and thereby may not be as regressive as a Btu energy tax. A broad-based consumption tax could encourage savings and investment, since the incidence of the tax is on the ultimate consumer of all domestically consumed goods and services.

Corporate Income Tax Rate

The President's proposal would increase the corporate income tax rate from 34 percent to 36 percent. The President proposes that the corporate tax rate increase be imposed retroactively to January 1, 1993.

EEI is concerned about two aspects of the proposed corporate tax rate increase. First, the proposal to increase the corporate tax rate unfairly taxes all industries, because it is retroactive. In particular, regulated electric utilities would not be able to recover this retroactive tax increase because the ratemaking process generally prohibits electric utilities from collecting the cost of a tax increase from customers until the electric service rates are adjusted. Regulatory proceedings normally require a nine to eighteen month period to complete. Electric rates are established prospectively, not retroactively; therefore, until such time, the opportunity to recover the proposed cost of a retroactive corporate income tax rate increase would be lost. Hence, the cost would be borne by the utility company and its shareholders, therefore, any tax rate increase should have an effective date which takes into account this regulatory delay.

Second, the increase in the corporate income tax rate will <u>not</u> affect tax-exempt municipal utilities, many cooperative utilities, and utilities operated by federal agencies. Investor-owned electric utilities compete with the tax-exempt electric agencies. Accordingly, the proposed increase in the corporate income tax rate would widen the tax advantage granted to tax-exempt electric agencies as compared to investor-owned electric utilities.

Incremental Investment Tax Credit

EEI supports the President's efforts to reenact the investment tax credit (ITC). The ITC is a proven incentive to stimulate investment in business machinery and equipment. However, the ITC should not be limited to incremental expenditures. An incremental

ITC is too complicated to administer effectively, and the complexity could lead to abuse. An incremental ITC is biased against mature businesses, such as electric utilities, that have substantial continuing investment in machinery and equipment. As a result, only a small portion, on average, of utility investment would qualify for an ITC. By contrast, new businesses have the opportunity to generate substantial amounts of ITC simply because the business is acquiring an initial incremental base of property. This creates an unfair competitive advantage by providing incentives to some industries at the cost of others. For example, a non-utility generator could receive an ITC to construct a plant, while a regulated utility would not receive ITC if it were to construct the same plant.

Therefore, EEI recommends that the investment tax credit be applicable to all qualified business property rather than incremental property.

Alternative Minimum Tax

EEI is pleased that the President has adopted a proposal to provide relief from the alternative minimum tax (AMT) and we recognize the Chairman of this Committee's commitment to the goal of AMT reform. The proposal would eliminate the special depreciation computation for the adjusted current earnings (ACE) adjustment. Additionally, the AMT proposal would change the AMT depreciation for personal property from the 150 percent declining balance method to the 120 percent declining balance method. These depreciation changes would apply to property placed in service after 1993.

The AMT proposal would give much needed relief from the AMT to capital-intensive industries such as the electric utility industry. The AMT depreciation adjustment and preferences are the chief reasons why more than 40 percent of our member companies have paid the AMT or have an AMT credit carryforward[22]. The President's AMT proposal will be a positive step toward reforming the AMT to remove its onerous impact on many capital-intensive companies.

Conclusion

EEI strongly supports the efforts of the Administration and the Congress to reduce the federal budget deficit and to promote a strong economic recovery. We acknowledge and appreciate the Administration meeting with representatives of our industry and listening to our views. In our view, the Administration's proposed Btu energy tax is counterproductive in accomplishing its stated goals. EEI believes that the best way to reduce the deficit and to improve the economy is to reduce and control government spending; however, if a major new tax is needed then we encourage you to thoroughly evaluate a broad-based consumption tax. The proposed Btu energy tax is unwise economic, environmental and energy policy. It would seriously damage the economic recovery and it will hurt U.S. international competitiveness. In addition, the Btu energy tax alters our Nation's energy policy and would result in questionable environmental benefits. If it is the will of the Congress that the proposed Btu energy tax should be enacted, then we recommend that the imposition of the tax be upon the consumer of electricity in the form of an excise tax. This would minimize the cost of the piggyback tax effects to our customers and maximize the opportunity to achieve the Administration's stated energy conservation and environmental goals. EEI appreciates the opportunity to present its views and we stand ready to assist this Committee and the Administration in their deliberations on this matter.

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[22] Edison Electric Institute. (1992) <u>Alternative Minimum Tax Survey.</u> (Washington, DC).

Mr. ANDREWS. Mr. Kanner.

STATEMENT OF MARTY KANNER, WASHINGTON REPRESENTATIVE, PUBLIC POWER COUNCIL, PORTLAND, OR

Mr. KANNER. Thank you, Mr. Chairman.

The Public Power Council is a regional trade association representing consumer-owned utilities in the Pacific Northwest. Because of the inherent regressive and inflationary nature of energy taxes, PPC has long opposed the adoption of any form of energy tax.

We applaud the administration for taking significant steps to mitigate the regressivity of the proposed tax and for exempting from taxation both energy conservation and nonconventional fuels. Nonetheless, PPC continues to oppose the energy tax in its current form due to the excessive tax burdens that would be placed on consumers of hydroelectric energy. And I would note that 65 percent of the electric needs of the Northwest are met through hydropower.

PPC believes the administration's proposed energy tax applies a scientifically invalid heat rate for hydropower resulting in excessive taxation of this energy source. Correction of this portion of the energy tax would not violate regional equity nor significantly reduce the revenue generated by this tax. In contrast, failure to assign the scientifically correct Btu value to hydropower will result in severe regional economic dislocation and discourage the use of an important renewable resource.

As the members of the committee are aware, the administration's energy tax is purported to tax each fuel based on its heat content as expressed in British thermal units. However, under the tax plan, hydropower is taxed at nearly three times its actual Btu equivalency.

Under the administration's proposal, the tax on hydropower is based on the Btu input of an average fossil fuel plant rather than the actual Btu equivalent of a kilowatt hour of electricity generated by falling water. The higher Btu number incorrectly assumes that converting falling water to electricity is as inefficient as generating electricity with fossil fuel.

The Btu rate in the administration's proposal is 10,315 Btu's per kilowatt hour. The correct number is 3,754. Administration officials concede that the imputed Btu value for hydropower is not scientifically justified. They suggest that the higher tax rate was necessary to create equity in the impact of the tax on different regions of the country. While this goal is understandable, in fact, the excessive hydropower tax appears to impose a disproportionate burden on the Pacific Northwest.

According to a preliminarily analysis of the tax based on Department of Energy data, the per capita increase in Montana would be 30 percent higher than the national average. In Washington, the impact is 20 percent above the national average. The impact in Idaho would be 5 percent above the national average and Oregon residents would be taxed at the national average.

According to an analysis by the Washington State energy office, taxpayers in the State "would still pay more than the national average, even if the hydropower tax were correctly calculated, owing to climate, long driving distances and energy-intensive industries."

Some will point to the lower electric rates in the Northwest and question how the tax on hydropower can be reduced without violating regional equity. It must be understood that the higher-than-average tax burdens in the region results primarily from the petroleum surcharge due to long driving distances.

According to the DOE data, the tax on oil will comprise 52 to 64 percent of the total energy tax burden within the States in the region. Correcting the Btu conversion rate for hydropower will not create a windfall for the Northwest, nor will this correction violate regional equity.

While the Pacific Northwest is historically characterized as having low electric rates, these rates are steadily rising. The estimate for the pending Bonneville Power Administration rate case has recently been revised upwards to an anticipated 27 percent increase. Resource acquisitions, Endangered Species Act compliance, and sustained drought are likely to result in additional rate increases of 20 percent over the next 2 years.

The administration's PMA repayment initiative, if adopted, will add a 4-percent rate increase, and if unadjusted, the energy tax will add an additional 12-percent increase to current BPA rates. If combined, the region would face a 60-percent increase in the cost of Bonneville power within 3 short years.

While the administration's energy tax is clearly designed to generate revenue for deficit reduction, this should not be an end in itself. Rather, it is the means of achieving the goal of long-term economic growth and fiscal health.

If the overarching purpose of the plan is the restoration and maintenance of a strong economy, then it must be recognized that the economic condition in the Pacific Northwest is extremely fragile and unlikely to sustain the impact of the proposed energy tax as currently calculated.

Sixty percent of Bonneville's energy sales go to industrial customers. Given the energy intensive nature of the Northwest economy, correcting the conversion factor for hydropower would provide much needed economic relief. This relief can be provided without dramatically decreasing the total revenue generated by the energy tax.

PPC urges Congress to tax hydropower at its actual energy value of 3,754 Btu's. Making this adjustment will ensure scientific consistency, regional equity, and economic vitality.

Mr. Chairman, I would note that other users of hydropower have concerns that are similar to those I expressed today, and I would respectfully request permission to have included in the record a statement by the National Hydropower Association.

Mr. ANDREWS. Thank you, Mr. Kanner. It will be included in the record.

[The prepared statement and statement of the National Hydropower Association follow:]

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Testimony of Marty Kanner, Washington Representative Public Power Council on the Administration's Proposed Energy Tax before the House Ways and Means Committee

March 23, 1993

I am Marty Kanner, Washington Representative for the Public Power Council (PPC). PPC is a trade association representing consumer-owned utilities -- rural electric cooperatives, public utility districts, and municipal utilities -- in the Pacific Northwest. Because of the inherent inflationary and regressive nature of energy taxes, PPC has long opposed the adoption of any form of energy tax. We applaud the Administration for taking significant steps to mitigate these negative impacts and for exempting from taxation energy conservation and nonconventional fuels. Nonetheless, PPC continues to oppose the energy tax in its current form due to the excessive tax burden that would be placed on consumers of hydroelectric energy.

PPC believes that the Administration's proposed energy tax applies a scientifically invalid heat rate to hydropower that results in excessive taxation of this energy source. Correction of this portion of the energy tax would not violate "regional equity," nor significantly reduce the revenue generated by this tax. Furthermore, failure to assign the scientifically correct Btu value to hydropower will result in severe regional economic dislocation and discourage the use of an important renewable resource.

Hydropower Is Central to Regional Power Supply and Economy

In order to appreciate the concerns of the Public Power Council with respect to the hydropower portion of the energy tax, it is necessary to understand the role of hydropower in meeting the region's energy needs and fueling the region's economy.

All of PPC's 115 member utilities meet a portion of their total bulk power supply needs through power purchases from the Bonneville Power Administration (Bonneville), and Bonneville serves the entire bulk power needs of approximately 85 of these utilities. Private power companies and certain large industrial consumers also receive large blocks of power from Bonneville. The power that Bonneville markets is almost exclusively generated at the federal multipurpose water projects of the Columbia River system. For those regional utilities that are partial requirements customers of Bonneville, utility owned hydro projects meet a large share of the remaining power needs. Consequently, through federal and non-federal projects, hydropower represents approximately 65 percent of the total electric generation of the region.

Much of the economy of the Northwest is based on the presence of reasonably priced and reliable electric supplies. Aluminum plants, pulp and paper mills, chemical companies, air processing facilities, and other energy-intensive industries have located in the Pacific Northwest, at least in part, because of affordable electric rates. As discussed further below, the price of electricity from the Bonneville Power Administration is escalating at a rapid pace. Soon, many of the energy-intensive industries in the region may be forced to close or relocate in Canada or overseas.

The region has been a showcase for conservation, fish mitigation and enhancement, and multiple use of an interstate waterway. However, without competitive electric rates, much of this success will be placed in jeopardy. As additional costs are imposed on the region's ratepayers, large industries will downsize, shut-down, or relocate, households will witness an ever increasing portion of their income dedicated to energy costs, and the ability of the region to finance these important programs will dwindle.

While some inside and outside the region have criticized the region's dependence on hydropower -- or its good fortune in securing once seemingly endless supplies of low-cost electricity -- few can discount the importance of cost-competitive hydropower to the economic vitality of the region.

Hydropower Taxed at Artificially High Rate

As the members of the Committee are aware, the Administration's energy tax is purported to tax each fuel based on its heat content as expressed in British Thermal Units (Btus). However, **under the tax plan, hydropower is taxed at nearly three times its actual Btu equivalency.**

A kilowatt hour of electricity has a heat value of 3,413 Btus. This is an undisputed, internationally recognized standard. Because hydropower projects operate, on average, at 90 percent efficiency (e.g., only 10 percent of the energy potential of falling water is lost in generating electricity), the Btu value of one kilowatt hour of hydropower is approximately 3,754 Btus. However, under the Administration's proposal, the tax on hydropower is based on the Btu input of an average fossil fuel plant -- 10,315 Btus per kilowatt hour -- rather than the actual Btu equivalent of a kilowatt hour of electricity generated by falling water.

This scientifically inaccurate and unjustifiable Btu value incorrectly assumes that hydropower is as inefficient as fossil fuel fired generation and results in nearly a tripling of the tax rate applied to hydropower. This excessive tax ignores the high efficiency of hydropower and discourages the use of this important renewable energy source.

Hydropower Tax Causes Regional Inequity

Administration officials concede that the imputed Btu value for hydropower is not scientifically justified. They suggest that the higher tax rate was necessary to create equity in the impact of the energy tax on different regions of the country. While this goal is understandable, in fact, **the excessive hydropower tax appears to impose a disproportionate burden on the Pacific Northwest.**

The U.S. Department of Energy has prepared a preliminary analysis of the per capita impact of the proposed tax. According to this analysis, the Pacific Northwest is disproportionately impacted by the proposed energy tax:

- Montana has the sixth highest burden with a per capita tax impact 30 percent higher than the national average;
- Washington comes in 12 with a per capita tax impact 20 percent above the national average;
- Idaho ranks 19, with a per capita tax impact 5 percent above the national average; and
- Oregon ranks 23, with a tax impact at the national average.

According to an analysis by the Washington State Energy Office, taxpayers in the state *"would still pay more than the national average even if the hydropower tax were correctly calculated, owing to climate, long driving distances, and energy intensive industries."*

Some will point to the lower electric rates in the Northwest and question how the tax on hydropower can be reduced without violating regional equity. It must be understood that the higher than average tax burden in the region results primarily from the petroleum surcharge due to long driving distances. According to the DOE analysis, the tax on oil will comprise 52 - 64 percent of the total energy tax burden within the states in the region. The higher than average tax impact in the region also reflects the more severe climate conditions (resulting in higher energy consumption for space conditioning), and the presence of numerous energy intensive industries.

Correcting the Btu conversion rate for hydropower will not create a "windfall" for the Northwest. Nor will this correction violate regional equity.

Energy Tax Could Cripple Northwest Economy

While the Pacific Northwest is historically characterized as having low electric rates, these rates are steadily rising. The pending Bonneville Power Administration rate case is likely to result in at least a 15 percent rate increase. Resource acquisitions, Endangered Species Act compliance, and sustained drought are likely to result in additional rate increases of 20 percent over the next two years. The Administration's PMA repayment initiative, if adopted, will add a 4 percent rate increase. If unadjusted, the energy tax will add an additional 12 percent increase to current BPA rates. Combined, the region could face a 50 percent increase in the cost of power within three years.

As previously mentioned, the economy of the Northwest is particularly energy intensive. Many large industrial consumers depend on low-cost energy supplies to remain competitive in international markets. For instance, the cost of electricity represents approximately one-third the cost of producing aluminum. According to the Direct Services Industries, an association of large Northwest energy consumers, aluminum plants in the Northwest pay average electric rates that are 20 percent higher than their world competitors. That differential will increase with adoption of the pending rate case and would increase further under the energy tax.

Aluminum plants are not the only energy-intensive industries in the Northwest. Energy costs are 25 to 35 percent of the cost of electrolytic chemicals produced in the region and 7-20 percent of the cost of pulp and paper.

While the Administration's energy tax is clearly designed to generate revenue for deficit reduction, this is not an end in itself. Rather, it is a means of achieving the goal of long-term economic growth and fiscal health. **If the overarching purpose of the plan is the restoration and maintenance of a strong economy, then it must be recognized that economic conditions in the Pacific Northwest are extremely fragile and unlikely to sustain the impact of the proposed energy tax as currently calculated.** Some examples of the weakness of the Northwest economy include:

- the world price of aluminum, due to dumping by the former Soviet Union, is very low with little sign of improving. Aluminum companies directly employ 10,000 workers;

- Boeing has recently laid off 27,000 workers;

- the recovery of the endangered spotted owl has cost thousands of jobs in the timber industry; and

- most major businesses are reducing their workforce and freezing salaries.

The current and future health of the region's economy is at stake. Access to cost-effective energy supplies is the region's economic lifeline.

Reducing the tax rate for hydropower to the scientifically correct energy rate of 3,754 Btus would provide much need economic relief to the Northwest without dramatically decreasing the total revenue generated by the energy tax. According to our calculations, the reduction in tax receipts would be approximately $500 million per year once the tax is fully phased in.

Because of the severe economic consequences of the resulting rate increase on Northwest businesses and industries, failure to adjust the tax on hydropower will likely result in a greater increase in the national deficit due to the likelihood of industry labor reductions, shut-downs and relocations.

Value of Hydropower Should be Recognized

Finally, it is important to recognize that the proposed energy tax is the first effort of the Administration to fashion an energy policy. The previously stated objectives of the Administration's energy policy are the encouragement of energy conservation, renewable resources, and environmentally sensitive fuel choices and the discouragement of foreign energy dependence. Given these objectives, use of existing hydropower projects should be advanced, not hindered. Hydropower:

- displaces foreign energy supplies;

- is an important renewable resource, representing 85 percent of our domestic renewable electric generating capacity;

- has less severe environmental impacts than traditional fossil-fired generation. While dams have impacted fish and wildlife and riverine habitat, to date Bonneville ratepayers have paid more than $1 billion to mitigate these impacts and will continue to pay at least $300 million per year -- for the foreseeable future -- on additional fish and wildlife expenditures; and

- its low-cost attributes, combined with enlightened utility planning, have enabled the region to pioneer the nation's most aggressive energy conservation program.

Accuracy, Equity, and Economy Justify Tax Rate Correction

PPC urges Congress to tax hydropower at its actual energy value of 3,754 Btus. Making this adjustment will ensure scientific consistency, regional equity, and economic vitality.

Statement of the National Hydropower Association Submitted to the House Ways and Means Committee March 23, 1993

NHA

The National Hydropower Association (NHA) supports the Clinton Administration's policy goals to encourage renewable energy, reduce greenhouse gases, and foster energy independence. We believe these are critically important objectives.

Yet, the proposed energy tax plan contained in President Clinton's deficit reduction proposal does not meet these key objectives in its treatment of hydroelectricity. As a domestically abundant, non-polluting, highly efficient and renewable resource, hydropower should be encouraged as the cornerstone of an environmentally sound energy tax proposal.

NHA's specific concerns and recommendations to ensure the fair treatment of hydropower in this area are listed below:

I. Hydropower is a Renewable Energy Resource

Existing hydropower resources provide over 85% of our nation's renewable energy resources. In comparing hydro with conventional fossil-fuel electric generation, Public Citizen estimated that energy produced by this country's hydro annually displaces the consumption of 530 million barrels of oil and the subsequent 249 million tons of carbon dioxide emissions. (In fact, this estimate is somewhat understated -- it would actually require about one billion barrels of oil to replace the electricity generated by hydropower annually.) Yet, despite its role as our nation's most valuable source of renewable generation, it has been included in the energy tax proposal while all other renewable resources have been exempted.

There are over 74,000 MW of undeveloped hydroelectric potential in the U.S. -- if only half of this capacity is developed, it would generate an amount of electricity equivalent to that produced by 20-25 large nuclear power plants, and would prevent the consumption of over 270 million barrels of oil. Clearly, a tax proposal designed to encourage renewable energy, energy efficiency and security must recognize the renewable benefits of hydropower and the vast potential for additional resources in this country -- and ensure that the resource is treated fairly.

Recommendation: Hydropower is a renewable resource and should be treated as such in all national policies. Renewables, conventional and non-conventional, should be treated alike. Should hydropower be included in the energy tax, it is vitally important that the American public knows that such a decision was based on regional fairness issues. It is critical that the inclusion of hydropower is not percieved as an indication of a lack of support for hydro as a valuable renewable resource.

II. A Tax Rate on Hydropower Should Reflect its High Efficiency

Hydroelectric plants are 85%-95% efficient -- very little energy is lost in the conversion of falling water to electricity. The current energy tax proposal has assigned hydro a conversion rate of 10,315 Btu/kwh reflecting only a 36% efficiency rate, the rate at which a coal plant converts its resources to energy. As a result, under the current plan, hydropower is taxed at a rate which is nearly three times that used for fossil fuels, despite the fact that it represents over 85% of our nation's renewable non-polluting energy generation and is highly efficient in its conversion of natural resources to energy.

Recommendation: The conversion rate for hydroelectricity should be lowered from 10,315 Btu/kwh to 3,792 Btu/kwh which is the corresponding conversion rate for 90% plant efficiency.

We believe this is a critical change necessary to ensure that hydropower is on a level playing field with other energy resources affected by the tax plan. In addition, the adoption of the lower rate will better reflect hydropower's renewable and efficient qualities, and will go a long way toward meeting the energy tax proposal's environmental objectives. In the end, the adoption of the lower conversion rate would result in less than a 2% impact in overall energy tax revenues collected.

III. Small Hydro Projects Should Be Exempted

The current tax proposal applies to all hydropower projects regardless of their size. Across the nation, small projects have been developed to meet local energy needs through the generation of renewable hydroelectricity. Despite the fact that many of these projects are very limited in scope and generating capabilities, they are subjected to the same regulatory processes as larger projects. The imposition of a tax on the electricity supplied by the 1,421 projects that are equal to or less than 5MW would place a significant new burden on these small generators, and would have the effect of discouraging local and community-based renewable energy development. In fact, these small projects can be deemed to be comparable to other non-conventional resources, such as solar and wind, which have been fully excluded from taxation under the current plan.

Moreover, a tax on projects equal to or under 5MW in size will not assist deficit reduction. While they represent an important trend toward efficient renewable development, these projects represent only one-tenth of one percent of our nation's overall energy capacity and only 3.9% of all Federal Energy Regulatory Commission authorized hydro capacity. NHA believes the costs of administering a tax on projects of this size would be higher than overall revenue contribution from such projects.

Recommendation: Hydroelectric projects under 5MW should be exempt from taxation. Taxation of small projects is not cost-effective, and would serve to discourage community-based renewable energy development.

IV. Pumped Storage Technology Should Be Exempted

Hydroelectric pumped storage is an energy management tool that improves the overall efficiency of a utility system, and provides energy storage capability necessary for periods of peak consumer demand. Because pumped storage projects provide stored energy which can be brought on-line almost instantaneously, utilities can avoid inefficient use of baseload units. As a result, pumped storage technology goes a long way toward attaining emission standards and improving the efficiency of a utility system through its inherent ability to respond to changes in the daily electric load. Moreover, as a source of stored energy, pumped storage provides a safety-net for utilities by ensuring that emergency power can be brought on-line immediately if needed.

A typical pumped storage facility has an upper reservoir, a lower reservoir, and one or more pump/turbines. Water is pumped from the lower to the upper reservoir during low energy demand periods to create stored energy. During peak consumer demand periods, the water is released back into the lower reservoir through hydro turbines to produce electricity. This peaking capacity is critical to a utility's ability to utilize non-dispatchable renewables, such as windpower. Without storage capability, such renewables often cannot be efficiently utilized, and may not be developed due to an existing excess of base-load within a system. Therefore, storage capability is of critical importance to the development of renewable resources within a utility system.

Pumped storage is radically different in nature from other energy technologies in that it requires energy to produce energy and to achieve its other efficiency and energy management benefits. Typically, off-peak power from excess base-load sources is used to pump water to an upper reservoir to be released when it is needed or valued the most. Because pumped storage both consumes and produces energy, it could potentially face double taxation under the existing energy tax proposal. Conceivably, a pumped storage operator would be forced to pay twice -- once for the fuel or energy used to pump water, and again for the energy produced by the facility. Double taxation on pumped storage threatens the economic feasibility of these facilities relative to other, fossil-fueled peaking resources.

Recommendation: Energy production from pumped storage facilities should be exempt from taxation.

Pumped storage is not a primary source of energy. According to the World Resources Institute, pumped storage contributes only 3% of the total U.S. electricity supply. It is important to evaluate whether or not such a small amount of generation would justify the administrative costs associated with the collection of a tax on this technology. In addition, because of its value as a source of stored energy which enhances efficiency, reduces emissions, and in some cases encourages the development of renewables within a utility system, pumped storage technology should be encouraged and such values should be reflected in the structure of an energy tax proposal.

Finally, the issue of double jeopardy for pumped storage facilities must be addressed to ensure fairness and to prevent this vitally important technology from being penalized and discouraged by federal tax policy.

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Hydro West Group, Inc.
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Preti Flaherty Beliveau & Pachios
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Northrop Devine & Tarbell Inc.
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Yuba Bear River Project
Colfax CA

PUD No. 1 of Okanogan County
Okanogan WA

Puget Sound Power & Light
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Kennebec Water Power Co.
Waterville ME

Henwood Energy Services
Sacramento CA

Allegheny Electric
Harrisburg PA

Edwards Manufacturing Co., Inc
Lisbon Falls ME

Voest-Alpine International Corp.
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Benham-Holway Power Group
Tulsa OK

STS Hydropower Ltd.
Northbrook IL

Voith Hydro
Arlington VA

Montana Power Co.
Butte MT

Stanley Consultants, Inc.
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Sithe-Energies USA
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PUD No. 1 of Douglas County
E. Wenatchee WA

HDR Engineering
Bellevue WA

Wisconsin Public Service Corp.
Green Bay WI

H & M Engineering, Inc.
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Troutman Sanders et. al.
Atlanta GA

Consolidated Hydro, Inc.
Greenwich CT

Oroville-Wyandotte Irrig. Dist.
Oroville CA

White River Hydroelectric Project
Batesville AR

Hydro Development Group
Dexter NY

Synergics Inc.
Annapolis MD

Niagara Mohawk Power Corp.
Syracuse NY

Pacific Hydro Consulting Group
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Sorenson Engineering
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New York Power Authority
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Hydro Review Magazine
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United American Energy
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Rath,Young, Pignatelli et.al.
Concord NH

NATIONAL HYDROPOWER ASSOCIATION MEMBERS

Yuba County Water Agency
Marysville CA

Washington Water Power Co.
Spokane WA

Idaho Power Co.
Boise ID

National Hydro Corp.
Boston MA

Mr. ANDREWS. Our next witness, from Texas, is the Honorable Barry A. Williamson, one of the railroad commissioners of Texas, and I would like to ask all of the the remaining witnesses to please try to pay attention to the three lights at the witness table.

We have 24 witnesses today, and if each of you will carefully try to keep your statements within the 5-minute range, it would be appreciated.

Mr. Williamson.

STATEMENT OF HON. BARRY A. WILLIAMSON, COMMISSIONER, RAILROAD COMMISSION OF TEXAS

Mr. WILLIAMSON. Mr. Andrews, Mr. Archer, members of the committee, I appreciate the opportunity to testify today. I am one of three statewide-elected officials for the Texas Railroad Commission. Chairman Jim Nugent and Mary Scott Nabers asked me to come to testify today to express their concerns and the State of Texas' concerns about the proposed Btu tax. Among our other duties, we regulate oil and gas and coal and intrastate transportation. We regulate production in Texas.

I was elected last November on my promise to work to create jobs in Texas. First, I support the President's goal of reducing the Federal budget deficit. A genuine budget deficit reduction will help us all. However, I am not persuaded that a tax is necessary to accomplish that goal. Several realistic but stringent cost-containment proposals have been detailed, and those must be given serious review before any tax increase is contemplated.

But, should it be necessary to consider a higher tax, I suggest the energy tax, as it is proposed, is a bad idea. It is a poor idea for three reasons: it has a disproportionate impact on energy-intensive areas, specifically Texas; it will cost American and Texas jobs in manufacturing and energy production; and it is an invitation for more, not less, foreign imports.

Let us talk about Texas for a minute. In 1990, the Department of Energy numbers showed Texas with the highest energy consumption in the Nation at 9.8 quadrillion Btu's. Our per capita Btu use in Texas is more than twice what it is for other residents, say for instance, Maryland, New York, California. Based on that data, Texas will bear 12½ percent of the tax, although we only have 6.8 percent of the population. And that is why I am here today.

Texas motorists consume 720 million gallons of gasoline a month. At 7.5 cents a gallon, that is $54 million a month in taxes. That is two-thirds of a billion dollars a year that we will pay just in gasoline taxes. But Texans do more than just drive. We work on farms and in factories. We make products and create stable jobs: Manufacturing, petrochemicals, mining, construction, agriculture. These are energy-intensive, job-rich industries which will be devastated by this type of a tax.

Energy is used to create things, to add value. By taxing the chief feature that makes our products competitive, you will be tying the manufacturers' hands behind their backs as they try to compete in a global marketplace.

Recently, I visited Cooper Industries in Houston. They manufacture precisely engineered products requiring a tremendous amount of energy. Adding to the cost by means of this energy tax would

crunch, if not eliminate, their profit margins in an international market. Low margins mean no expansion, no new hiring, no corporate tax revenues and perhaps more layoffs. To make a long story short, this tax is not a job-creating proposal.

Adopting a multibillion dollar summer jobs spending program, while placing high-pay, high-wage manufacturing jobs at peril is not a good idea. We should be bending over backward to save high-paying jobs in this country and not placing them at risk.

This new tax is a job loser also in the energy production sector as well because the seller will bear a significant share of the proposal. Those producers I have talked to recently operate on strict cash flow requirements. They need the cash; they must make the sales. As a result, they have to eat the tax; they cannot pass it along.

Last week I was in Midland, TX. I met an individual who is an energy producer, a small energy producer. He has been a growing energy producer, and he indicated this tax will cost him 11 percent of his gross profits in 1994 and 20 percent in 1995.

You may ask why, why do we assume that the producer will pay the energy tax? That is simple. The energy market is highly competitive. That is why prices have been relatively low over the last few years. If one supplier, say a low-cost Canadian producer, is willing and able to absorb the new tax surcharge, he will make the sale. The competing producer, like my friend Tripp Wommack from Midland, in my example, will lose the sale. In order to get that sale, Tripp must absorb more and more of the surcharge, and the spiral inevitably leads to Tripp absorbing all the tax. Placing a tax on top of the current price will only exacerbate the problem.

Natural gas producers—this is not theory, we have been living with this, natural gas producers in the real world. All you have to do is look at the pass-back surcharges that FERC has applied the last few years. It goes back up the pike.

The additional squeeze on the producers' market for this new tax means they will have little choice but to shut in marginal production. First of January 1993, we had 246,000 wells in Texas; 77 percent of them were marginal production, producing less than 10 barrels a day. These wells employ thousands of people and contribute tens of millions of dollars to our State treasury. We estimate their economic value at $11 billion. If you have this tax, it will put that value at peril.

This is why over the past few weeks we have been traveling the State and talking to the State legislature to come up with tax incentives to remove State severance taxes, but this particular Federal tax will obliterate our efforts in that regard.

The various problems would become somewhat mitigated, the problems I mentioned, if the point of tax collection were moved as close as possible to the ultimate consumption points, for instance, at the utility city gate or at the refined product distribution point. In the last 10 years, we lost 450,000 jobs in this industry; 170,000 in Texas. New field discoveries are at an all-time low. We have lost 51 percent of our exploration business and we have shut down 27 refineries in Texas.

Energy used to be the cornerstone of the Texas economy, 30 percent of the tax base; now it is only 8 percent. Texas cannot afford to continue to lose the tax base.

The energy tax also would increase imports because we are the marginal producer. Overseas, they can produce energy at less cost; therefore, they will be able to recover the cost more easily. As a result, we will continue to lose more of our domestic production.

In closing, I would like to note that our national economy is as successful as it is because we have been blessed with abundant energy supplies in this country and have successfully adapted to many changes over the years. Along the way, the energy sector has taken some hard body blows. The loss of good jobs and State revenues have caused a dramatic transformation of the Texas landscape, but we have swallowed hard and survived and we continue to grow.

The search for the Federal deficit reduction must begin with Federal Government spending reductions, and my message today is clear: Balance the budget here in Washington and not on the backs of hard working men and women.

Thank you, Mr. Chairman.

[The prepared statement follows:]

WRITTEN TESTIMONY OF COMMISSIONER BARRY WILLIAMSON, RAILROAD COMMISSION OF TEXAS

Mr. Chairman and Members of the Committee:

I am one of the three statewide-elected members of the Railroad Commission of Texas. Among other duties, we are charged with regulating oil, gas, and coal production in the State of Texas. In addition to conserving natural resources and preserving property rights, the Railroad Commission is charged with protecting the environment in all of our endeavors. I hope my perspective as a regulator of practically every major energy source used in the country will be useful in helping you better understand how the proposed energy tax will affect Texas and our nation. And thank you for this opportunity to appear here before you today.

Over its 102 years, the Railroad Commission has had the task of balancing the various statutory charges placed on us by the Legislature with the mandate to ensure the overall health of the various energy industries. Among the numerous challenges we have balanced in Texas are:

- increased competition from international energy supplies (including the market-distorting impacts of oil cartel activities),

- protecting air and water quality in the State and nation,

- the drop in energy-derived state tax revenues,

- the many technological advances in energy extraction and production techniques, and

- the painful but necessary transition in natural gas from a highly regulated industry to one driven mainly by market forces.

I thought you would want to know what the people in Texas have to say about the Administration's energy policy. As part of my job, I get out around the State to talk to producers and consumers, assessing resource development and conservation efforts as well as environmental concerns. I am hearing from landowners, mom-and-pop independents, major oil and gas producers, municipal utility companies, electric generators, farmers, manufacturers and taxpayers.

I was elected last November on my promise to the people of Texas to work hard on the Commission to help create more jobs in the vital Texas energy sector while protecting the broader long-term interests of the State of Texas. Any supporter of this energy tax who looks to isolated players in the energy industry for political "cover" is: (a) not talking to the people who will be directly impacted by it, and (b) not going to like what I have to say.

As an initial point, I support the President's goal of reducing the federal budget deficit. A genuine reduction in the federal deficit will benefit <u>everyone</u>. However, I am not persuaded that a tax increase is necessary to accomplish that goal. Several realistic but stringent cost-containment proposals have been detailed, and those must be given <u>serious</u> review before <u>any</u> tax increase is contemplated.

Should it be necessary to consider higher taxes, however, I suggest that the energy tax, as it has been proposed, is a poor idea. It is a poor idea because it is a tax on the energy sector at a time when this nation needs this industry to rebuild our economy and reestablish the independence we have historically enjoyed.

Over the past decade, more than 450,000 jobs were lost in the oil and gas industry. Tax revenues derived from oil and gas have dropped from 30 percent to 8 percent in Texas. These are the revenues that go to funding education, prisons and health care.

As the Energy Belt of America is slowly waking up from the nightmare and readjusting painfully to the brave new world, it cannot bear the brunt of a new tax specifically directed at energy. This tax is a poor idea for three principal reasons:

1. its impact will <u>not</u> be fair and equitable but will single out one region of the country with the resulting loss of jobs,

2. depending on the point of collection, this tax will not be "broad-based," but will be borne instead by producers, mostly independents and smaller production companies, who are just now emerging from a severe depression, and,

3. it runs counter to the national security and environmental goals touted by its supporters.

<u>Collection of the Proposed Energy Tax Will Not Be "Broad Based" But Will Injure the Recovering Energy Belt</u>

There are two ways of evaluating the impact of this tax -- at the production end and at the consumption end -- and Texas is a loser on both counts. I believe that, depending on how the President's energy tax is ultimately formulated, it will directly impact producers of energy. Even if the collection problems are addressed, this tax will still have a disproportionate impact on Texas consumers because of our high energy usage.

Let's talk about Texas. 1990 Department of Energy data show that the energy consumption in Texas is the highest in the country -- some 9.8 <u>quadrillion</u> Btus, and our per capita Btu use in Texas is more than <u>twice</u> what it is, for example, for residents of Maryland, California and New York. By one well-supported estimate, Texas would bear 12.5 percent of the energy tax burden while having only 6.8 percent of the nation's population.

Texas motorists consume 720 million gallons of gas each month. With the 7.5 cents (or more) tax burden that the President's energy tax would place on gasoline, that would add a burden of at least $54 million per month to Texans. (That's 2/3rds of a billion dollars each year -- just from driving). But Texans do more than drive. We work on farms and in factories. We make products and create stable jobs. This tax would have a tremendous negative economic impact on those energy-intensive, job-rich industries that thrive in Texas: manufacturing ($29.7 billion in total 1990 wages), petrochemical ($16.2 billion), mining ($8.4

billion), construction ($8.6 billion), and agriculture ($1.3 billion).

Energy is used to create things, to add value. By taxing the one feature that makes American, and specifically, Texas products competitive, you would be tying the hands behind our manufacturers' backs as they fight for competitive advantage in a global economy. You would be eliminating our competitive advantage across the board.

We need to encourage industries that make things. In Texas, a tremendous amount of energy is used to manufacture and produce products which add benefit to the nation. Actions which retard expansion of energy-intensive industries make it more profitable to perform low-value-added paper transactions than to actually produce domestic products.

Recently, I visited a major industrial manufacturer in Houston. Its finely-engineered products are textbook models of American know-how. As with many other goods exported from the large Port of Houston, the manufacturing processes used to create these products are energy-intensive. Energy is used to forge the steel, run the complex machines tooling the steel, and drive the numerous post-production processes. Petroleum is also the base source of the many plastics which constitute the final product. These expenses are rolled into the cost of the final American product.

When the costs of energy to this industrial user are increased by a surcharge (to the extent it hasn't already been absorbed by the energy producer), either that cost is passed on to buyers of the manufactured good or it is absorbed by the company. For products that are competitively priced abroad today, it is likely that the costs will have to be absorbed by the company. To remain competitive, the Houston manufacturer will, most likely, have to bear the increased costs within the company's operations, or risk losing the sale. This means less money to invest in expansion, new technology, job training, or new employee hiring. In more drastic cases, it may mean seeking cost savings within the company by letting people go -- or in foregoing annual pay raises for the work force. This is <u>not</u> what I would call a job-creating proposal.

Why the country needs to adopt a multi-billion dollar summer job spending program while raising taxes which place high-wage manufacturing jobs at peril simply does not make sense.

We should be bending over backward to <u>save</u> the good jobs we have in this country, not eliminating them or placing them in jeopardy.

<u>The Energy Tax, As Designed, Will Have A Serious Detrimental Effect on the Recovering Energy Production Sector</u>

Much of the cheerleading for the so-called "broad-based energy tax" is founded on the misconception that it is the consumer who will pay the whole bill. This leads some people to the conclusion that the tax will be spread evenly over the country, impacting each region relatively equally.

If the point of collection for this tax is anywhere other than at the final point of sale, most of the tax will actually be borne by producers -- not consumers. The fact is -- surcharges and taxes go right back "up the pipe," as we say, and come out of the producers' pockets.

In natural gas, for example, we have a decade of experience with FERC-approved surcharges to study. A unit surcharge (assessed by the pipeline on each unit of capacity and/or of gas) has been used to recover some $7-8 billion in "take-or-pay" contract claims. This was another "tax" intended to be borne by all natural gas consumers in the country.

That premise could not have been more incorrect. The natural gas industry found out the hard way that, like with an unwanted "collect call," the wrong guy paid the bill. The impact of those surcharges is still being felt -- although it appears that the worst is finally past. The proposed Btu tax appears to be a "first cousin" to this disastrous tax design theory.

The reason these taxes and surcharges are borne by the producer is that oil and gas are highly competitive products -- competitive with each other and among themselves. The only days of the year when surcharges are truly borne by the consumer are on those five or ten peak energy-use days each year when the market is supply-driven, not demand-driven.

Most onshore and offshore producers I have talked with recently operate under strict cash flow requirements from their banks. They need the cash and must make the sale. This includes absorbing additional, externally-imposed costs, such as the FERC surcharges, or this new federal Btu tax.

If one supplier (say, a low-cost Canadian producer) is willing and able to absorb the surcharge, he will make the sale; a competing U.S. seller will lose the sale. In order to get a sale, the U.S. seller in this example must absorb more and more of the surcharge, and the spiral inevitably leads back to total absorption of the tax by the seller.

This competitive situation already exists in energy markets. A tax on top of the current price will only exacerbate the problem.

The point of collection of a tax determines who will actually pay the tax. It also determines how domestic producers are treated with respect to foreign competitors. If that tax is collected at the wellhead or even where the producer delivers the gas to a pipeline, then that tax is undoubtedly going to be borne by the producer.

Although I find the February 24, 1993 analysis of the energy tax by the CBO's Robert Reischauer before the Senate Energy and Natural Resources Committee generally correct, I found he skimmed over this critical issue. This "collect call" impact of taxes and surcharges may be one of the best-kept secrets in Washington, but it is of deadly serious concern in the energy patch. Most of the independent producers that I have visited with over the past several weeks are enraged about it. They are enraged because this reality coincides with the swirl

of rumors from Washington that the Btu tax and the double hit on oil are intended to put them out of business.

Another often-overlooked aspect of placing the point of collection at or near the wellhead is the administration problem. There are literally tens of thousands of oil and gas wells and operators in the country -- as of January 1, 1993, there were 246,117 producing oil and gas wells in Texas alone. Ensuring proper tax collection from each one will be difficult and costly, to say the least. If it must be, the tax should be paid by the final consumer and collected by the ultimate seller.

Similarly, the collection point for the oil Btu tax has important impacts. Because of the competition from foreign sources, which are increasingly coming to the United States in refined form, the assessment of any tax on crude coming into the refinery and not on the final product would favor imports and possibly close more domestic refineries. We've already lost 27 refineries in Texas in the past decade. In Texas, as elsewhere in the country, those closures cost jobs and make us more, not less, dependent on foreign sources of energy.

I think it goes without saying that the "collect call" impact and the collection problem would be somewhat mitigated if the point of tax collection were moved as close as possible to the ultimate consumption point, for instance, at the utility city gate or at the refined product distribution point.

Regardless of the Point of Collection, the Proposed Energy Tax Will Shut In a Significant Amount of Domestic Production

In the last 10 years the domestic oil and gas industry has lost some 450,000 jobs -- more than any other industry. New field discoveries and drilling are at an all-time low, so new reserves are not being lined up for future use. 51 percent of the exploration jobs have either gone overseas or have been lost altogether. The refining business is off 28 percent; in Texas we have seen the closure of some 27 refineries. Energy, once the cornerstone of the State's tax base, has dwindled. Texas simply cannot afford to lose any more of this industry.

The additional pressure of a tax, seen in the context of a fiercely competitive international market for oil and gas, will inevitably lead to shutting in many marginal wells. About 77 percent of Texas' oil wells (134,276 wells) and 41 percent of Texas natural gas wells (20,646 wells) are stripper wells producing less than 10 barrels/day of oil and 60 Mcf/Day of natural gas. These stripper wells employ thousands of people and contribute tens of millions of dollars per year to the State treasury. The Railroad Commission's Economic Value Estimates (analyzing the total impact of this production on the Texas economy) for these marginal wells is $11.30 billion per year.

That is why these past two weeks my colleagues and I have worked with members of the Texas Legislature to actively promote several State severance tax incentives for exploration, drilling and production in Texas. I am not up here to sell those ideas to you, but suffice it to say that everything we could do through Texas regulatory and tax codes to create new jobs and increase production will be

more than wiped out by the imposition of the new federal energy taxes on these same businesses and people we are trying to help.

The State of Texas has a 7.5 percent severance tax on natural gas and a 4.6 percent severance tax on crude oil. Even if we were able to totally exempt all new production from those taxes (an outcome I doubt our Legislature would support), the effects of the proposed new federal tax would obliterate our efforts.

The Energy Tax Will Not Achieve the Additional Goals Touted by its Supporters

The Energy Tax will Lead to Greater, not Fewer, Energy Imports

The reason this country imports as much foreign oil as it does is that the easily, cheaply recoverable sources in the United States have largely been discovered and produced. It is now necessary to drill deeper to find new fields. Exploratory seismic testing to find those fields is far more complex and more expensive. Protection of the environment during exploration and production as well as during construction of pipelines isn't cost-free, either. In addition, banks are much more cautious about financing an increasingly risky business.

The bottom line is -- it costs more to produce reserves here than it does overseas. Even with substantial transportation costs rolled in, foreign oil is competitive with our own oil because, by and large, it is cheaper to find and produce. We also have placed many significant offshore (Outer Continental Shelf) areas with large potential for natural gas or oil production off limits for the next decade.

As a consequence, domestic production and refining have declined significantly. Additional costs which would be placed on top of that sector, particularly in light of the "collect call" situation discussed earlier, will shrink it even more. Marginal production will become uneconomic and investors will shift to more productive investments.

Our demand for oil is relatively inelastic, so the disappearance of domestic production will lead to more not fewer foreign oil imports.

Therefore, I question the "double hit" proposal, which would add a surcharge to the tax on all oil, regardless of source. If there has to be any energy tax, it seems to me that a surcharge which is placed only on foreign oil supplies would, at least, prevent domestic producers from being placed at a disadvantage to foreign producers and prevent further contractions in domestic oil employment and production.

The oil-on-oil competition that would result would, in all likelihood, keep the price at its current level since foreign suppliers can afford to (and would) discount the base price of their oil to maintain market share in this, their largest market. In such a case, the absorption of the Btu surcharge by the foreign supplier would be virtually guaranteed; foreign oil suppliers, then, would help the United States reduce its federal deficit.

The "national security" aspect of the "double hit" oil surcharge rings a bit hollow to offshore producers I talked to in Houston recently. They question whether any realistic drop in oil imports will be observed so long as significant new domestic discoveries in offshore waters are prohibited by federal fiat. From my own experience as a former Director of the federal Minerals Management Service, I have to agree. Trying to sell this energy tax as a national security program is a bit disingenuous when the best solution to imported oil lies right off our shores.

The Energy Tax Doesn't Make Good Environmental Sense

I think it goes without saying that we all are more aware of environmental impacts of various activities than we were ten years ago. I salute the Congress for its passage of the Clean Air Act Amendments in 1990. Provisions in that Act were favorable to alternative fuels and to greater natural gas use.

In Texas, we have adopted a brisk implementation schedule for conversions to alternative fuels (natural gas, propane and methanol), requiring that 90 percent of public fleets to be converted by 1998. In addition, the Legislature has set up a $2.7 million/year program to support marketing of propane, and we are seeking a similar program to support natural gas marketing and vehicle conversion efforts.

Natural gas was supposed to be "the fuel of choice for the 90's," yet under the latest version of the energy tax, the price of a standard unit of natural gas will rise some 15 percent. Also, propane and methanol, which are composed chiefly of natural gas, would be taxed at the higher oil tax rate. Is this plan really how we want to favor clean, domestic energy sources? These fuels need to be encouraged, not discouraged.

Environmental issues related to this tax manifest themselves in other ways. When producers go bankrupt, plugging their abandoned wells (sealing them up) is often an impossibility for them. Because of safety concerns and environmental concerns, it is vitally important to Texas that these wells be plugged. In fact, the Legislature has recently given the Railroad Commission responsibility to plug abandoned wells. Texas has the only publicly-funded plugging program in the nation.

However, it will be more than ten years before all unused wells are located and plugged in Texas. Thus, for many reasons, we at the Commission would rather have a producing oil or gas well than an abandoned well.

Conclusion

Energy is the lifeblood of our country. Our economy is as successful as it is because we have been blessed with abundant energy supplies and have successfully adapted to changes in those supplies over the years. In adapting to these changes, however, the energy sector has recently taken some hard blows. The loss of good jobs and State revenues has caused a dramatic transformation in the Texas landscape, but we have swallowed hard and directed our energies toward making a better future.

As a Commissioner in an agency that is as frugal as any I have ever seen in government, I believe strongly that the search for federal deficit reduction must begin with federal government spending reductions. I am encouraged that the President has recently expressed an interest in the cost-containment measures and agency audits we have been implementing in Texas State government over the past few years. I am also encouraged by the recent serious alternative plans which call for deeper reductions in spending in lieu of tax increases.

In closing, my message is clear: balance the budget here in Washington, and not on the backs of hardworking men and women.

Mr. ANDREWS. Mr. Nagel.

STATEMENT OF HON. DENNIS J. NAGEL, CHAIRPERSON, IOWA UTILITIES BOARD, AND PRESIDENT, NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Mr. NAGEL. Thank you, Mr. Chairman, and members of the committee. I serve as chairperson of the Iowa Utilities Board and president of the National Association of Regulatory Utility Commissioners, or NARUC, on whose behalf I testify today. The NARUC greatly appreciates this opportunity to appear before the committee to present its views on the proposed energy tax.

Earlier this month, the NARUC executive committee adopted a resolution rescinding our 1990 position opposing broad-based energy taxes and taking a position of neutrality on the issue for now. While this resolution does not advocate a position for or against the President's Btu tax proposal, its does state six issues NARUC believes must be addressed in the design of any broad-based energy tax including the President's proposal. A copy of this resolution is attached with NARUC's written testimony.

Because my written statement goes into greater detail on each of these six items contained in the resolution, I want to use my time this morning to focus on two major points, possible preemption of State regulatory authority and assistance to low-income ratepayers.

One of the fundamental principles of our association is to oppose any form of Federal preemption of States' regulatory authority. I raise this at the outset because the NARUC is aware of options to modify the President's proposal that would, in essence, mandate the passthrough of the tax to utility ratepayers.

A mandatory passthrough requirement, such as via amendments to the existing normalization rules of the U.S. Tax Code, would preempt State commissions' ability to balance all the factors involved in setting utility rates. We also question the need for such a mandatory requirement given the lack of evidence to warrant it.

We are not aware of any State commission today denying the recovery of Federal taxes paid by a utility. In fact, the majority of State commissions allows utilities to passthrough to ratepayers increases in the cost of their fuel, including increases due to taxes, through what are commonly known as fuel adjustment clauses in the electric utility industry and purchase gas adjustments in the tax utility industry.

These adjustments to utility rates are done periodically, either monthly, annually, or on some other basis depending on each commission's rules. Our written testimony includes a summary of those rulings. I commend you to it.

Some States, however, do not have these adjustment mechanisms in place. In those instances, State commissions either hold special hearings dedicated to fuel cost increases of utilities or review these at the time of the utility's general rate proceeding.

There is a related issue that could impact the passthrough issue I have just discussed; that is the issue of where the point of collection for the tax will be. We are aware that there are some discussions to move the points of collection as far downstream as possible

and have, in effect, the utility customers bear directly the entire cost of the tax.

Consistent with our resolution, NARUC believes such a proposal would leave little or no discretion to State utility commissions. In addition, it is not clear collecting the tax only on utility customers would meet the goals of encouraging energy efficiency and assisting our Nation's use of cleaner technologies and renewable resources. For these reasons, NARUC would have to oppose such a provision.

The second issue I want to address is the issue of the impact of any broad-based energy tax on low-income utility cost matters. The NARUC believes any tax proposal must have a component that mitigates the impact on low-income utility ratepayers. We are aware that the President's proposal includes certain offsets.

The NARUC has consistently supported funding for these programs as the best insurance that low-income ratepayers will be able to meet their energy bills. Yet in recent years, the effectiveness of these programs have been diminished by reduced Federal funding. We urge Congress to appropriate sufficient funds for these programs to restore their effectiveness in reaching the people who most need the assistance as well as making up for the increased energy cost that would result from the imposition of a broad-based energy tax.

Of course, any broad-based energy tax would directly impact the ratepayers of the utilities we regulate. At this time we are open-minded about the President's Btu tax proposal. Our position neither favors nor opposes the tax as it has been originally proposed. However, as our resolution states, if there is to be a broad-based energy tax, there are certain principles that must be part of the package.

There are several difficult issues associated with the implementation of a broad-based energy tax. I have touched on two of those today. My written comments address the remaining issues.

We pledge the NARUC is willing to work with your committee, Mr. Chairman, the Congress, and the administration in determining what proposals would be in the Nation's best interest.

Thank you. I would be glad to answer any questions.

[The prepared statement follows:]

TESTIMONY OF

THE HONORABLE DENNIS J. NAGEL
CHAIRPERSON, IOWA UTILITIES BOARD

ON BEHALF OF THE

NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS

Chairman Rostenkowski and Members of the Committee:

Good morning. I am Dennis Nagel, Chairperson of the Iowa Utilities Board and President of the National Association of Regulatory Utility Commissioners (NARUC), on whose behalf I am testifying here today. The NARUC greatly appreciates the opportunity to present its views on the subject of the President's energy tax proposal.

The NARUC is a quasi-governmental, nonprofit organization founded in 1889. Within its membership are the governmental agencies of the fifty States, the District of Columbia, Puerto Rico and the Virgin Islands engaged in the regulation of carriers and utilities. NARUC's chief objective is to serve the public interest by seeking to improve the quality and effectiveness of regulation.

Introduction

The NARUC takes the matter of energy taxes very seriously. In fact, President Clinton's proposed BTU tax on fuel sources of energy commanded a great deal of attention and debate during the NARUC's recently concluded Winter Committee Meetings. In all, three of our committees, the Committees on Electricity, Energy Conservation and Gas, debated and took action on resolutions addressing the issue of broad-based energy taxes. The result of these deliberations was final action in the Executive Committee of the Association, which adopted a resolution rescinding a 1990 NARUC resolution opposing broad-based energy taxes and taking a position of neutrality on the issue for now. A copy of this resolution is attached to this statement (Attachment #1). While this resolution does not advocate a position for or against President Clinton's BTU tax proposal, it states what issues the NARUC believes should be addressed in the design of any broad-based energy tax, including the President's proposal.

In my statement today, I would like to explain further each of the items contained in our resolution and how they relate to what we know about the President's BTU tax proposal. Let me say that although we know the outlines of the President's BTU tax, there are important details about it that are still being discussed. We have discussed the proposal with the Administration and other interested parties and are continuing these discussions. As the State agencies responsible for regulating the rates and services of electric and gas utilities, we have a great deal to contribute to the National debate about energy taxes. There seems to be little doubt that any energy tax proposal will impact the Nation's electric and gas utility ratepayers, and with this in mind, we enter this debate knowing that there will be real costs imposed on real people, whose interests we are sworn to protect.

The President's BTU tax proposal is part of a comprehensive package that is designed to reduce the Federal budget deficit as well as encourage long-term economic growth. The NARUC in rescinding its earlier resolution did so, in part, because the President's BTU tax proposal was a component of a larger package of economic proposals and that these combined with the BTU tax would not only cut the deficit but help promote future economic growth.

No Restrictions on State Discretion in Treatment of Costs

Federal taxes, whether they are excise or income taxes, are part of the costs of a utility's business. The NARUC believes that the costs associated with an energy tax should be treated no differently than any of the other costs that are included in the State regulated utility rate-setting process. In fact, the majority of State commissions allow utilities to pass through to ratepayers increases in the cost of their fuel -- including increases due to taxes -- through what are commonly known as fuel adjustment clauses in the electric utility industry and purchased gas adjustments in the gas utility industry. These adjustments to utility rates are done periodically -- either monthly, annually or on another basis -- depending on the State commission's rules.

(See Attachment #2 for a summary of State commission policies regarding fuel adjustment clauses and purchased gas adjustments.) Some States, however, do not have fuel adjustment mechanisms in place. In those instances, State commissions will either hold special hearings to deal with fuel cost increases of utilities or review these at the time of the utility's rate proceeding.

A mandatory requirement that costs associated with an energy tax should be passed through to ratepayers i.e. via amendments to the existing normalization rules of the U.S. tax code would pre-empt State commissions' ability to set rates according to the process of balancing all the factors involved. If a mandatory passthrough requirement is established, a State commission reviewing the costs associated with a utility's operations would have no choice but to increase rates to customers even though the utility experienced substantial cost reductions e.g. due to the recent decline in long-term interest rates or restructuring its operations.

For the reasons stated above, the NARUC believes that any pre-emption of States' ratemaking authority in this area is unwarranted and unsupported by the past experiences of State commissions in dealing with Federal taxes paid by electric or gas utilities.

Geographic Equity and Fairly Spread Over All Fuels

The resolution we adopted calls for any broad-based energy tax to be applied in a manner that assures geographic equity in tax burdens and to assure that the tax burdens will be spread fairly over all fuel sources, including hydro. This part of our resolution deals with the issue of making any energy tax as fair as possible to all those who will be affected by it. By applying the tax to all fuel sources for electric generation, we believe that some measure of geographic equity can be achieved with respect to the potential impact on utilities and their customers in different regions of the country. In addition, we believe that the tax should be applied to all fuel sources so that it is not only the utility fuel sector that is affected. The President's BTU tax proposal appears to meet this objective by including fuels used for electric utility generation as well as fuels used in other sectors of the economy.

Encourage Energy Efficiency and Optimal Use of Fuels

Energy efficiency as many of you know was the cornerstone of the recently enacted Energy Policy Act of 1992 (P.L. 102-486). The NARUC took an active role in supporting many of the energy efficiency provisions of this legislation. Consistent with this past effort and with our continuing support of promoting cost-effective energy efficiency investments by electric and gas utilities, we believe that any broad-based energy tax should be designed to further promote energy efficiency efforts not only by regulated utilities but in all sectors of the economy. We are concerned that the level of energy efficiency acquired through an energy tax may be affected by the point at which it is assessed. Based on our resolution, we believe that it should be applied where it encourages the greatest total amount of energy efficiency and efficient use of fuels. Although our country has made progress in terms of reducing its energy consumption and improving its energy efficiency, the potential for more energy efficiency gains is tremendous. Energy efficiency also can lead to other benefits for our country such as increased competitiveness in world markets. As recognized by Congress in the Energy Policy Act, the United States can and should do more to increase the efficient use of energy among all its industries.

Consistent With Transition to Cleaner Technologies/Renewable Resources

The NARUC has advocated the development of renewable energy

technologies. The association was supportive of provisions under the Energy Policy Act to provide investment and production tax incentives for renewable energy technologies, which this Committee worked on in the last Congress. We did so based on evidence that renewable energy technologies lag behind conventional energy technologies in their acceptance by utilities and other businesses as sources capable of producing clean, cost-effective electric power. As we understand the President's tax proposal, renewable energy sources would be exempt from the BTU tax. This part of the proposal appears to meet our objective. However, careful consideration should be given to determining what technologies should qualify for exemptions from the BTU tax. For example, an expansive definition of biomass facilities would include facilities that have been shown to have significant environmental impacts.

Contribute to U.S. Productivity, Technology Export Opportunities and Competitiveness

As our resolution states, the design of any broad-based energy tax must contribute toward making the United States more productive, and encourage greater export opportunities and competitiveness. All of these objectives can in some measure be accomplished through increased energy efficiency. As I indicated briefly before, the NARUC believes that energy efficiency provides real benefits for the nation. By making our country's industries more energy efficient, we enhance our ability to compete in world markets. In addition, it may spur development of clean energy technologies in the U.S. that have great export potential. The effect of energy taxes on the energy component of the products we produce and export, however, should not be overlooked. These additional costs must be weighed against the incentive an energy tax would create to cut energy costs of producing domestic goods and services.

Offset Impacts on Low-Income Customers

The fifth point of our resolution addresses the issue of impacts resulting from a broad-based energy tax on low-income utility customers. The NARUC believes that any energy tax proposal must mitigate the regressive impacts on low-income utility ratepayers. We are aware that the President's proposal would include offsets such as an expanded earned income credit and increased funding for the Low-Income Home Energy Assistance Program (LIHEAP) and the Department of Energy's Low-Income Weatherization Assistance Program (WAP). Our resolution also supports efforts aimed at providing "education and targeted energy efficiency" for low-income ratepayers to help them reduce the overall use of energy. The NARUC has consistently supported funding for the these programs as the best insurance that low-income ratepayers are able to meet their energy bills. Yet in recent years the effectiveness of these programs has been diminished by reduced Federal funds. We would urge Congress to consider funding these programs to restore their effectiveness in reaching the people who most need them as well as making up for the increased energy costs that would result from the imposition of an broad-based energy tax.

Other Issues

There are other important issues that could impact the pass through issue I have just discussed but which our resolution does not specifically address. These are the points of collection and the treatment of the energy tax in contracts signed between independent power producers and regulated utilities.

We are aware that there are discussions to move the points of collection as far "downstream" as possible and have in effect the utility customers bear the entire cost of the tax. It may have significantly different effects in encouraging energy efficiency and the development of cleaner and renewable energy technologies. Consistent with the NARUC resolution and our historic opposition to

Federal excise taxes, we believe that such a proposal would amount to directly passing on the cost of the tax to utility ratepayers and thereby leave no discretion to State utility commissions. In addition, it is not at all clear that collecting the tax only on utility customers would meet the goals of encouraging energy efficiency and assisting our Nation's use of cleaner technologies and renewable resources. For these reasons, the NARUC would have to oppose such a proposal.

We also are aware of efforts to correct any financial difficulties that would result in contracts entered into between independent power producers and the utilities to which they sell their power. Consistent with our resolution and our position concerning wholesale power sales involving State-regulated electric utilities, the NARUC believes that Congress should not mandate that utilities pass through the increased costs related to the energy tax as part of the utilities' contracts with independent power producers, cogenerators or any affiliated or non-affiliated entity selling power to a utility.

Investment Tax Credits

Unrelated to the issue I have discussed above, but which is part of the President's overall tax package, is the revival of the investment tax credit, which was repealed by the Tax Reform Act of 1986. Revival of the ITC would mean that utilities would be allowed to claim credit against current and future income for their investments in qualifying assets. The current tax code requires a "normalization" treatment of these credits, which would mean that the benefits are passed on to ratepayers over the lifetime of the utility's asset. The NARUC opposes mandatory normalization treatment of ITC. If normalization is required, we would advocate that current tax law be changed to apply economic normalization to the ITC, allowing more of the benefits of ITC to be passed on to ratepayers.

Conclusion

As I said at the outset, energy taxes are a serious matter for State commissioners; they directly impact the ratepayers of the electric and gas utilities we regulate. At this time, the NARUC is open minded about the President's BTU tax proposal. However, we don't wish our position to be construed as favoring or opposing it. As our resolution states, if there is to be a broad-based energy tax, there are certain principles that must be part of the package. There are several difficult issues associated with the implementation of any broad-based energy tax. I have discussed some of them with you today, and pledge that the NARUC is willing to work with your Committee, the Congress and the Administration in determining what proposal is the best for our country.

Thank you. I would be happy to answer any questions that you may have.

ATTACHMENT #1

Resolution on the Design of Energy Taxes

WHEREAS, The Administration and members of Congress will be considering adopting a broad-based energy tax as part of a comprehensive package of actions to address the Federal deficit and long-term economic growth; and

WHEREAS, State regulated utility ratepayers and shareholders will be affected by any such tax through its impacts on costs, energy efficiency, and utility resource decisions; and

WHEREAS, By covering a portion of the economic impact not currently reflected in the price of fuels, a properly designed tax policy which encourages energy efficiency may have long-term positive economic benefits by increasing U.S. productivity and competitiveness as well as avoiding or mitigating detrimental environmental impacts of resource decisions; and

WHEREAS, The National Association of Regulatory Utility Commissioners (NARUC) previously adopted a resolution opposing a general broad-based energy tax at a time when such taxes were being considered solely as a method to reduce the deficit and not as part of any comprehensive economic plan; and now, therefore, be it

RESOLVED, That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), convened at its Winter Meeting in Washington, D.C., hereby rescinds the previous resolution on energy taxes adopted July 26, 1990; and be it further

RESOLVED, While the NARUC does not support or oppose a broad-based energy tax at this time, the NARUC Executive Committee believes that any broad-based energy tax as part of a comprehensive package of actions to reduce the Federal deficit and spur long-term economic growth should:

(1) be applied in a manner that assures geographic equity in tax burdens and assures that the tax burdens will be fairly spread over all fuels, including hydro;

(2) be designed to encourage energy efficiency and the optimal use of fuels;

(3) be consistent with the transition to use of cleaner technologies and renewable resources;

(4) contribute to U.S. productivity, technology export opportunities and competitiveness;

(5) be accompanied by programs that offset impacts on low-income customers, including education and targeted energy efficiency programs that help reduce the use of energy; and

(6) not restrict State regulatory commissions' discretion in the treatment of costs associated with the imposition of energy taxes.

Sponsored by the Committees on Electricity and Energy Conservation
Adopted March 3, 1993

ATTACHMENT #2

SECTION 4

ENERGY COST ADJUSTMENT CLAUSES - ELECTRIC AND GAS

Table 24 displays electric utility use of energy cost adjustment clauses, whether a hearing is required prior to recovering costs, whether periodic filings are required, what types of costs may be recovered via adjustment clause and whether the agency uses a true-up procedure for over- or under-recoveries.

Table 25 displays the same information for gas utilities.

TABLE 24 - REGULATION OF ELECTRIC UTILITY ENERGY COST ADJUSTMENT CLAUSES

FAC=Fuel Adjustment Clause AGENCY *	Has Authority to Establish Energy Cost Adjustment Procedure?	The Agency: Allows Use of FAC to Recover Cost Changes	Requires FAC Hearing Prior to Cost Recovery? SEE KEY BELOW	Requires Periodic FAC Filing(s)? SEE KEY BELOW	Allows Changes in these Cost Components to be Recovered by Way of Fuel Adjustment Clause (FAC)? Fuel Costs	Purchased Power: Energy Charge	Purchased Power: Demand Charge	Other	Uses a True-up Procedure for Over- or Under-Recoveries
FERC	YES	YES	NO	NO	YES	YES	NO	§35.22(e) R&D	YES
ALABAMA PSC	YES	YES	NO	I	YES	YES	NO	Taxes not assessed uniformly statewide (ie, municipal tax)	YES
ALASKA PUC	YES	YES	NO	Q, O	YES	YES	YES	Interest expense.	YES
ARIZONA CC	NO 7/	NO 1/	Rate Case	M	YES	YES	NO 1/		
ARKANSAS PSC	YES	YES	NO	M	YES	YES	YES	Municipal franchise tax. Co-ops - cost of debt adjustment 9/	YES
CALIFORNIA PUC	YES	YES	YES and Annually	A	YES	YES	YES	Increased franchise fees. Uncollectibles associated with revenue change.	YES
COLORADO PUC	YES	YES	NO,Annual	M, A	YES	YES	YES	Interchange power.	YES
CONNECTICUT DPUC	YES	YES	YES and Annually	M	YES	YES	NO	Savings shares to FAC & PGA revenues, generation utilization.	YES
DELAWARE PSC	YES	YES	YES	A	YES	YES	YES		YES
DC PSC	YES	YES	NO	M	YES	YES	YES		YES
FLORIDA PSC	YES	NO	YES & S	M, S	YES	YES	YES	Conservation costs.	YES
GEORGIA PSC	NO	NO	YES	I	YES	YES	NO	Transportation.	YES
HAWAII PUC	YES	YES	In Rate Case	I	YES	YES	NO	Public service company tax. Public utility fee. Franchise tax on gross revenues.	YES
IDAHO PUC	YES	NO 2/	YES 2/						
ILLINOIS CC	YES	YES	NO, Annually	M	YES	YES	YES	Ad Valorem taxes on large use rates that are priced close to costs. Gross revenue taxes as affected by cost increase collected via FAC.	YES
INDIANA URC	YES	YES	Q	Q	YES		NO	Steam/Hydro generatio	YES
IOWA UB	YES	YES	NO	I	YES	YES	YES		YES
KANSAS SCC 15/	YES	YES	YES for purchased power	M	YES	YES	YES	Costs included in FERC Acct 151, less refunds Acct 555 - co-ops. Acct 555 less demand, capacity & fixed charges for IOUs. Limestone for scrubbers, other. KCC 106,850-U.	YES
KENTUCKY PSC	YES	YES	NO, S & B	M	YES	YES	NO	FERC Acct 151-transp.	YES
LOUISIANA PSC	YES	YES	YES & M	M	YES	YES	NO	Transportation/taxes	YES
MAINE PUC	YES	YES	NO, Annually	A, M	YES	YES	YES	Conservation cost, indirect fuel cost.	YES
MARYLAND PSC	YES	YES	YES & S	I	YES	YES	YES		YES
MASSACHUSETTS DPU	NO	YES	YES & Q	Q	YES	YES	YES		YES
MICHIGAN PSC	NO	YES	YES and Annually	A	YES	YES	YES	O&M expenses other than fuel, electric production maintenance costs.	YES
MINNESOTA PUC	YES 3/	YES	NO	M	YES	YES	NO		
MISSISSIPPI PSC	YES	YES	YES	NO	YES	YES	NO	Transportation/taxes	YES
MISSOURI PSC	NO 10/	NO							
MONTANA PSC	NO	NO							
NEVADA PSC	YES	NO	YES, A	A	YES	YES	YES	Capacity costs	YES

NOTE See also Table 67 for Audits performed in conjunction with Fuel Adjustment Clause.

A=Annually
S=Semi-Annually
Q=Quarterly
M=Monthly
O=Other Regular Timeframe
I=Irregular Interval or As Necessary

Fuel Adjustment Clause (FAC) is the term used generically to refer to energy cost adjustment procedures for electric utilities.

TABLE 24 - REGULATION OF ELECTRIC UTILITY ENERGY COST ADJUSTMENT CLAUSES (Continued)

FAC=Fuel Adjustment Clause AGENCY *	Has Authority to Establish Energy Cost Adjustment Procedure?	The Agency: Allows Use of FAC to Recover Cost Changes	Requires FAC Hearing Prior to Cost Recovery? (SEE KEY BELOW)	Requires Periodic FAC Filing(s)? (SEE KEY BELOW)	Allows Changes in these Cost Components to be Recovered by Way of Fuel Adjustment Clause (FAC)?: Fuel Costs	Purchased Power: Energy Charge	Purchased Power: Demand Charge	Other	Uses a True-up Procedure for Over- or Under-Recoveries
NEW HAMPSHIRE PUC	YES	YES	YES & M,S	M, S	YES	YES	NO		YES
NEW JERSEY BRC	YES	YES	YES	A	YES	YES	YES	Revenue taxes and energy losses.	
NEW MEXICO PSC	YES	YES	NO	M		YES	YES		YES
NEW YORK PSC	YES 3/	YES 5/	NO, Hearings held min 4 yrs	M	YES	YES	YES	Changes in city/village revenue tax surcharges.	NO
NORTH CAROLINA UC	NO	YES	YES and annually	A	YES	YES	NO	Energy portion of interchanged power.	YES
NORTH DAKOTA PSC	YES	YES	min 4 yrs	M	YES	YES	NO		
OHIO PUC	NO	YES 6/	NO, semi-annually	M, S, A	YES	NO	NO	System loss, Ohio coal R&D costs.	YES
OKLAHOMA CC	YES	YES	NO, semi-annually	M	YES	YES	YES	All items charged to fuel in FERC accounts	YES
OREGON PUC	YES	NO							
PENNSYLVANIA PUC	YES	YES	NO	Q, A	YES	YES	NO	Taxes on corp. stock, net income, gross receipts, realty.	YES
RHODE ISLAND PUC	YES	YES	YES	Q, O		YES	NO		YES
SOUTH CAROLINA PSC	YES	YES 8/	NO, S	S	YES	YES	NO	Interchange power.	YES
SOUTH DAKOTA PUC	YES	YES	NO		YES	YES	NO		YES
TENNESSEE PSC	YES	YES	NO	M	YES	YES	YES		
TEXAS PUC	NO	NO							
UTAH PSC	NO	YES	YES, I, S	M	YES	YES	NO	QF energy, geothermal	YES
VERMONT PSB 11/	NO	NO							
VIRGINIA SCC	NO	NO	YES	I	YES	YES	YES	Uses Projected Fuel Factor.	YES YES
WASHINGTON UTC	YES 14/	NO							
WEST VIRGINIA PSC	NO	YES	YES, A	A	YES	YES	YES	Off system sales.	YES
WISCONSIN PSC	YES	NO 4/	NO, A	A	YES	YES	NO	Transportation.	
WYOMING PSC	YES	NO	12/						
VIRGIN ISLANDS PSC	YES	YES	YES						
ALBERTA PUB	YES	YES	YES	M	YES	YES	YES		
NOVA SCOTIA PUB 16/		NO						Fuel cost built into rates.	

NOTE See also Table 67 for Audits performed in conjunction with Fuel Adjustment Clause.

A=Annually
S=Semi-Annually
Q=Quarterly
M=Monthly
O=Other Regular Timeframe
I=Irregular Interval or As Necessary

Fuel Adjustment Clause (FAC) is the term used generically to refer to energy cost adjustment procedures for electric utilities.

** For greater detail on PGA and FAC, consult "Current PGA and FAC Practices: Implications for Ratemaking in Competitive Markets", November 1991, National Regulatory Research Institute-NRRI 91-13.

FOOTNOTES - TABLE 24

1/ Automatic fuel adjustment clause was eliminated in November 1978 for investor-owned electric utilities.
2/ One electric utility has power cost adjustment clause to reflect changes in hydro-generation due to abnormal stream flows; subject to evidentiary proceeding.
3/ Commission permits utilities to file rate schedules containing provisions for automatic adjustment of charges.
4/ Effective with their first rate case held after July 2, 1983, investor-owned electric utilities which generate more than half of their energy requirements may not have an automatic adjustment clause.
5/ Utilities required to justify continuation of fuel adjustment clauses on an individual basis.
6/ Automatic fuel adjustment clause was eliminated as of 1/01/79 for investor-owned electric utilities. Fuel cost rate changes every 6 months, after hearing and commission order. Company may include demand cost or purchased economic power.
7/ In 1989 Commission eliminated adjustment clause for two large electric utilities.
8/ Adjusted on a semi-annual basis.
9/ "Other" - other areas of automatic adjustment clauses - not included in energy cost adjustment, but as a separate line item. Purchased power for water/sewer utilities.
10/ In Missouri the fuel adjustment was ruled unconstitutional for electric service on October 1, 1979. See: Utility Consumers Council of Missouri v. Public Service Commission, 562S.W.2d688.
11/ Abolished by Vermont Supreme Court Ruling in Docket No. 4496/4504, 1984.
12/ Opportunity for Hearing (Notice).
13/ Commission requires each regulated gas and electric utility to file its cost of fuel adjustment calculations for review and approval prior to implementation. In 1987 changed to annual review and adjustment.
14/ Energy cost adjustment clause previously authorized to one IOU electric was eliminated January 1990 and replaced in April 1991 with a limited adjustment clause.
15/ Eliminated April 1992 as a condition of approval of the merger of KPL and KG&E.
16/ Commission did not respond to request for update information; this data may not be current.

TABLE 25 - REGULATION OF GAS UTILITY ENERGY COST ADJUSTMENT CLAUSES

PGA=Purchased Gas Adjustment Clause AGENCY **	Has Authority to Establish Energy Cost Adjustment Procedure?	The Agency Allows Use of PGA to Recover Cost Changes	Requires PGA Hearing Prior to Cost Recovery? SEE KEY BELOW	Requires Periodic PGA Filing(s)? SEE KEY BELOW	Allows Changes in these Cost Components to be Recovered by Way of Purchased Gas Adjustment Clause (PGA)? Commodity Costs	Demand Costs	Transport Charge	Other	Uses a True-up Procedure for Over- or Under-Recoveries
FERC	YES	YES	NO	O, A	YES	YES	YES	§35.22(e) R&O	YES
ALABAMA PSC	YES	YES	NO	A, I	YES	YES	YES	TOP, GIC, storage, competitive fuel clause adjustments.	YES
ALASKA PUC	YES	YES	NO	Q	YES				YES
ARIZONA CC	NO	YES 3/		M	YES	YES	YES 1/	TOP liability.	
ARKANSAS PSC	YES	YES	NO	M	YES	YES	YES	Municipal franchise tax. Co-ops - cost of debt adjustment 4/	YES
CALIFORNIA PUC	YES	YES	YES and Annually	A	YES	YES	YES	TOP, GIC, storage, administrative costs associated with fuel procurement.	YES
COLORADO PUC	YES	YES	YES & A	A	YES	YES			YES
CONNECTICUT DPUC	YES	YES	YES and monthly, quarterly	M	YES	YES	YES	Savings shares to PGA revenues, GIC, storage, refunds, etc.	YES
DELAWARE PSC	YES	YES	YES & S/A	S, A	YES	YES	YES	TOP, GIC, Storage.	YES
DC PSC	YES	YES	NO	M	YES	YES	YES	TOP, GIC, Storage.	YES
FLORIDA PSC	YES	YES	YES & S	S	YES	YES	YES	TOP, GIC, Storage.	YES
GEORGIA PSC	YES	YES	NO	I	YES	YES	YES	TOP, GIC, Storage.	YES
HAWAII PUC 11/	YES		NO	I				Public service company tax. Public utility fee. Franchise tax on gross revenues.	
IDAHO PUC	YES	YES	YES	A, I	YES	YES	YES	TOP, GIC, Storage.	YES
ILLINOIS CC	YES	YES	NO, Annually	M, A	YES	YES	YES	Ad Valorem taxes on large use rates that are priced close to costs. Gross revenue taxes as affected by cost increase collected via PGA. TOP, GIC, Storage.	YES
INDIANA URC	YES	YES	YES	Q, S	YES	YES	YES	TOP, GIC, Storage.	YES
IOWA UB	YES	YES	NO	I	YES	YES	YES	TOP, GIC, Storage.	YES
KANSAS SCC	YES	YES	NO	A, M	YES	YES		Costs included in FERC Acct 151, less refunds Acct 555 - co-ops. Acct 555 less demand, capacity & fixed charges for IOUs. Limestone for scrubbers, other. KCC 106,850-U. Storage.	YES
KENTUCKY PSC	YES	YES	NO, S & B	Q, S	YES	YES	YES	TOP liability.	YES
LOUISIANA PSC	YES	YES	YES, A	M	YES	YES	YES	TOP, taxes.	YES
MAINE PUC	YES	YES	NO, Annually	S	YES	YES	YES	Conservation cost, indirect fuel cost. TOP, Storage.	YES
MARYLAND PSC	YES	YES	NO, S	M	YES	YES	YES	TOP, GIC, Storage.	YES
MASSACHUSETTS DPU	YES	YES		S	YES	YES	YES	TOP, GIC, Storage, interest.	YES
MICHIGAN PSC	NO 10/	NO							
MINNESOTA PUC	YES 1/	YES	NO	Q, I	YES	YES	YES	TOP, Storage.	YES
MISSISSIPPI PSC	YES	YES	NO	NO	YES	YES	YES	TOP, GIC, Storage.	YES
MISSOURI PSC	YES	YES	NO	I	YES	YES	YES	TOP, GIC, Storage.	YES
MONTANA PSC	NO	YES	YES	A, B	YES	YES	YES	TOP, Storage.	YES

NOTE See also Table 67 for Audits performed in conjunction with Purchased Gas Adjustment Clause.

A=Annually
S=Semi-Annually
Q=Quarterly
M=Monthly
O=Other Regular Time
I=Irregular Interval or As Necessary
B=Biannually

Purchased Gas Adjustment Clause (PGA) is the term used generically to refer to energy cost adjustment procedures for gas utilities (LDCs).

TABLE 25 - REGULATION OF GAS UTILITY ENERGY COST ADJUSTMENT CLAUSES (Continued)

PGA=Purchased Gas Adjustment Clause AGENCY **	Has Authority to Establish Energy Cost Adjustment Procedure?	The Agency: Allows Use of PGA to Recover Cost Changes	Requires PGA Hearing Prior to Cost Recovery? (SEE KEY BELOW)	Requires Periodic PGA Filing(s)? (SEE KEY BELOW)	Allows Changes in these Cost Components to be Recovered by Way of Purchased Gas Adjustment Clause (PGA)?: Commodity Costs	Demand Costs	Transport Charge	Other	Uses a True-up Procedure for Over- or Under-Recoveries
NEVADA PSC	YES	YES	YES, A	A	YES	YES	YES	Capacity costs	
NEW HAMPSHIRE PUC	YES	YES	YES & S	B, S	YES	YES	YES	TOP, Storage	YES
NEW JERSEY BRC	YES	YES	YES & A	A	YES	YES	YES	Revenue taxes, energy losses, TOP, Storage.	YES
NEW MEXICO PSC	YES	YES	NO, B	M	YES		YES	Market based GIC.	YES
NEW YORK PSC	YES 1/	YES	NO	M	YES	YES	YES	TOP, GIC, Storage, changes in local tax surcharges.	YES
NORTH CAROLINA UC	NO	YES	NO	S	YES	YES	YES	TOP, market based GIC and Storage.	YES
NORTH DAKOTA PSC	YES	YES	NO	NO	YES	YES	YES		YES
OHIO PUC	YES 2/	YES	YES	Q	YES	YES	YES	TOP, GIC, Storage, propane.	YES
OKLAHOMA CC	YES	YES	NO, semi-annually	M	YES	YES	YES	All charged to gas in FERC accts., TOP.	YES
OREGON PUC	YES	YES 6/	NO, S, A	A	YES	YES	YES	Storage, interest.	YES
PENNSYLVANIA PUC	YES	YES	NO, annually	I	YES	YES	YES	Taxes on corp. stock, net income, gross receipts, realty. GIC, Storage.	YES
RHODE ISLAND PUC	YES 11/	YES	YES & A	A	YES	YES	YES	TOP, GIC, Storage.	YES
SOUTH CAROLINA PSC	YES	YES	NO, S	M, S	YES	YES	YES	TOP, GIC, Storage.	YES
SOUTH DAKOTA PUC	YES 5/	YES	NO	NO	YES	YES	YES	TOP, GIC, Storage.	YES
TENNESSEE PSC	YES	YES	NO	I	YES	YES	YES	TOP, GIC, Storage.	YES
TEXAS RC 11/	YES	YES	NO	M					
UTAH PSC	NO	YES	YES, I, S	S, A	YES	YES	YES	TOP, gathering.	YES
VERMONT PSB 7/	NO	NO							
VIRGINIA SCC	YES	YES 3/	YES	Q	YES	YES	YES	TOP, GIC, Storage.	YES
WASHINGTON UTC	YES	YES	YES, A	NO	YES	YES	YES	TOP, deficiency based GIC, Storage.	YES
WEST VIRGINIA PSC	YES	YES	YES, S, A	A	YES	YES	YES	TOP liability.	YES
WISCONSIN PSC	YES	YES	NO, A	A	YES	YES	YES	TOP, deficiency based GIC, Storage.	YES
WYOMING PSC	YES 9/	YES	8/	A, O	YES	YES	YES	TOP, GIC, Storage.	YES
VIRGIN ISLANDS PSC	NO	NO							
ALBERTA PUB	NO	YES	YES	M	YES	YES	YES		
NOVA SCOTIA PUB 11/	YES	NO							
QUEBEC NGB	YES	YES	NO						

NOTE See also Table 67 for Audits performed in conjunction with Purchased Gas Adjustment Clause.

A=Annually
S=Semi-Annually
Q=Quarterly
M=Monthly
O=Other Regular Time
I=Irregular Interval or As Necessary
B=Biannually

Purchased Gas Adjustment Clause (PGA) is the term used generically to refer to energy cost adjustment procedures for gas utilities (LOCs).

** For greater detail on PGA and FAC, consult "Current PGA and FAC Practices: Implications for Ratemaking in Competitive Markets", November 1991, National Regulatory Research Institute-NRRI 91-13.

1/ Commission permits utilities to file rate schedules containing provisions for automatic adjustment of charges.
2/ Automatic fuel adjustment clause was eliminated as of 1/01/79 for investor-owned electric utilities. Fuel cost rate changes every 6 months, after hearing and commission order. Company may include demand cost or purchased economic power.
3/ Subject to Commission approval.
4/ "Other" - other areas of automatic adjustment clauses - not included in energy cost adjustment, but as a separate line item. Purchased power for water/sewer utilities.
5/ Required by Statute.
6/ Purchased gas adjusted on a six-month or twelve-month basis - no automatic adjustment.
7/ PGA abolished in 1985.
8/ Opportunity for Hearing (Notice).
9/ Commission requires each regulated gas and electric utility to file its cost of fuel adjustment calculations for review and approval prior to implementation. In 1987 changed to annual review and adjustment.
10/ Abolished in 1982.
11/ Commission did not respond to request for update information; this data may not be current.

Mr. ANDREWS. Mr. Fry.

STATEMENT OF PAUL R. FRY, DEPUTY EXECUTIVE DIRECTOR, AMERICAN PUBLIC POWER ASSOCIATION

Mr. FRY. Thank you, Mr. Chairman and members of the committee. I am Paul Fry, deputy executive director of the American Public Power Association.

APPA is a national service organization representing more than 1,750 municipal and other local, publicly owned electric utility systems. These utilities serve 15 percent of the Nation's electric consumers and are located in 49 of the 50 States. We appreciate this opportunity to present our views on the administration's economic stimulus, public investment, and deficit reduction proposals.

I would like to use my time to comment specifically on the proposed energy tax. APPA has a history of opposition to energy taxes. This opposition has been based on concerns about the inequitable regional distribution of the burdens of such taxes, the difficulty of ensuring fair and efficient administration, potential adverse effects on international competitiveness, and the fact that an energy tax is inherently regressive.

Despite this history, last month APPA's Legislative and Resolutions Committee voted to suspend this policy of opposition, and to examine the administration's proposal in the spirit of accommodation. While APPA continues to be concerned by the inherent regressiveness of energy taxes, including the proposed Btu tax, and by the potentially unequal burdens such taxes may impose, we are willing to accept a Btu tax provided; No. 1, that the tax revenues are used for the purpose of deficit reduction; No. 2, that the tax law contains a sunset provision; No. 3, that the tax is fair for different fuels, regions, customer classes, and electric utility industry sectors; No. 4, the tax is structured with an eye to fair and efficient administration; and finally, that the regressive nature of the tax is mitigated.

Like the majority of Americans, APPA supports the goal of deficit reduction. This shared goal is the major reason our association is willing to accept the idea of an energy tax. If the administration's economic package is successful, it could mean lower longrun costs for all consumers. It is essential, however, that energy tax revenues be applied to deficit reduction.

At the same time, our members believe that the Btu tax should not be perpetual. They recommend that there be a sunset feature that cancels the Btu tax automatically and coincidentally with the end of the administration's economic package. This is intended to trigger a mandatory review of the degree of success the tax may have had in reducing the deficit. It would also permit a reconsideration of the fairness of the tax and permit an evaluation of unforeseen effects.

We assume that the overriding purpose of the Btu tax is to raise revenue. The design of the tax appears to have been crafted with an eye to spreading the burdens as evenly as possible among the regions of the country. APPA recognizes some regional inequities remain and efforts to correct them will occur. If the revenue goals of the tax are to be maintained, any tinkering with the tax will be a zero-sum game.

A tax reduction for one State or region will require a tax increase for some other States or regions. Modifications of the Btu tax as proposed must be guided by concern for an equitable distribution of the tax burdens.

The administration has proposed that the Btu tax be imposed close to the production level. APPA agrees with this general proposition on the grounds that it will entail fewer taxpayers and, hence, be less costly to administer and more difficult to evade. We are concerned, however, that there be no layering of other taxes on top of the Btu tax. No tax on the tax should be permitted.

For instance, gross receipts taxes or similar levies. Likewise, severance taxes and royalties should not be applied to that portion of a fuel's price occasioned by the Federal Btu tax.

We understand that the administration intends that the full burden of the Btu tax will be borne by the end users of energy. In keeping with this intention, we urge that there be no prohibition of an electric utility's right to itemize the Btu tax on bills to ultimate consumers. It should also be made clear that Federal facilities are responsible for their fair share of the tax applied to their electricity bills.

The fact that the proposed energy tax is regressive must be recognized and addressed. One effective means of mitigating the burdens of the tax on those least able to afford it is to provide adequate funding to the existing low-income home energy assistance programs, or LIHEAP. LIHEAP is a needs-based, block grant program to help low-income households pay household energy costs.

APPA strongly urges that the trend of decreased funding for LIHEAP be reversed, and additional funds be provided to meet existing needs and to offset the impact of the proposed Btu tax.

Thank you, Mr. Chairman.

Mr. ANDREWS. Thank you, Mr. Fry.

[The prepared statement follows:]

TESTIMONY OF THE

AMERICAN PUBLIC POWER ASSOCIATION

ON THE ADMINISTRATION'S PROPOSALS FOR

PUBLIC INVESTMENT AND DEFICIT REDUCTION

BEFORE THE

HOUSE WAYS AND MEANS COMMITTEE

MARCH 23, 1993

Mr. Chairman, Members of the Committee, I am Paul R. Fry, Deputy Executive Director of the American Public Power Association (APPA). APPA is a national service organization representing more than 1,750 municipal and other local, publicly owned electric utility systems. These utilities serve fifteen percent of the nation's electric consumers -- approximately thirty-five million Americans.1/ Public power systems are owned by, and are accountable to, the people they serve. APPA's member utilities are located in forty-nine of the fifty states, only Hawaii is excepted.

I. SUSPENSION OF CATEGORICAL OPPOSITION TO ENERGY TAXES

We appreciate this opportunity to present our views on the Administration's economic stimulus, public investment and deficit reduction proposals. I would like to comment specifically on the proposed energy tax and then briefly address some of the other provisions of particular interest to public power systems.

APPA has a history of opposition to energy taxes. This opposition has been based on concerns about the inequitable regional distribution of the burden of such taxes, the difficulty of ensuring fair and efficient administration, potential adverse effects on international competitiveness and the fact that an energy tax is inherently regressive.

Despite this history, last month, APPA's Legislative and Resolutions Committee voted to suspend this policy of opposition, and to examine the Administration's proposal in a spirit of accommodation.

In addition, APPA President Robert E. Roundtree appointed a broad-based task force of public power leaders from throughout the country to chart specific interim policy positions in response to Administration proposals affecting public power.

II. CONCERNS WITH PROPOSED BTU TAX

While APPA continues to be concerned by the inherent regressiveness of energy taxes, including the proposed Btu tax, and by the potentially unequal burdens such taxes may impose, we are willing to accept a Btu tax provided:

(1) tax revenues are used for deficit reduction;

(2) the tax law "sunsets" in 1998;

1/ See attached charts for details of U.S. electric utility industry structure by ownership type, generating capacity by fuel type, etc.

(3) the tax is fair to different fuels, regions, customer classes and electric industry sectors;

(4) the tax is structured with an eye to fair and efficient administration; and

(5) the regressive nature of the tax is mitigated.

A. Importance Of Deficit Reduction

Like a majority of Americans, APPA supports the goal of deficit reduction.

This shared goal is the major reason our association is willing to accept the idea of an energy tax. If the Administration's economic package is successful, it could mean lower long-run costs for all consumers. It is essential, however, that energy tax revenues be applied to deficit reduction.

B. Desirability of Sunset Provision

At the same time, our members believe that the Btu tax should not be perpetual. They recommend that there be a "sunset" feature that cancels the Btu tax automatically and coincidently with the end of the Administration's economic package. This is intended to trigger a mandatory review of the degree of success the tax may have had in reducing the deficit. It would also permit a reconsideration of the fairness of the tax and permit an evaluation of unforeseen effects.

C. Fairness

We assume that the overriding purpose of the Btu tax is to raise revenue. The design of the tax appears to have been crafted with an eye to spreading the burden as evenly as possible among the regions of the country. APPA recognizes that some regional inequities remain and efforts to correct them will occur. If the revenue goals of the tax are to be maintained, any tinkering with the tax will be a zero-sum game.

A tax reduction for one state or region will require a tax increase for some other state or region. Modifications of the Btu tax as proposed must be guided by concern for an equitable distribution of the tax burden.

D. Design and Administration

The Administration has proposed that the Btu tax be imposed close to the production level. APPA agrees with this general proposition on the grounds that it will entail fewer taxpayers and, hence, be less costly to administer and more difficult to evade.

Electric utilities with hydroelectric or nuclear generating facilities are proposed as the collection points for those energy sources.

We are concerned, however, that there be no layering of other taxes on top of the Btu tax. No "tax on the tax" should be permitted, for instance, gross receipts taxes or similar levies. Likewise, severance taxes and royalties should not be applied to that portion of a fuel's price occasioned by the federal Btu tax.

We understand that the Administration intends that the full burden of the Btu tax will be borne by the end users of energy. In keeping with this intention, we urge that there be no prohibition of an electric utility's right to itemize the Btu tax on bills to ultimate consumers. It should be made clear that federal facilities are

responsible for their fare share of the tax applied to their electricity bills.

Also, the allocation of the tax among a utility's customer classes should remain within the sole discretion of the utility or appropriate regulatory body.

E. Mitigation of Regressiveness

The fact that the proposed energy tax is regressive must be recognized and addressed. One effective means of mitigating the burden of the tax on those least able to afford it is to provide adequate funding to the existing Low-Income Home Energy Assistance Programs (LIHEAP). LIHEAP is a needs-based, block grant program to help low-income households pay household energy costs. APPA strongly urges that the trend of decreased funding for LIHEAP be reversed, and additional funds provided to meet existing needs and to offset the impact of the proposed Btu tax.

III. DISCUSSION OF FUEL-SPECIFIC FAIRNESS ISSUES

APPA offers the following suggestions regarding some fuel-specific fairness issues:

A. Hydro power. Hydro power is our nation's most abundant renewable resource, accounting for approximately 12 percent of our total installed electric generating capacity. It will continue to make a significant contribution to our energy mix. Federal policy should encourage its use, both development of additional hydro power facilities and relicensing of existing facilities.

1. Pumped Storage. The Administration's proposal may impose a double tax on pumped storage hydroelectric projects -- taxing the fuel (or the electricity itself) used to generate the electricity needed to pump water to the storage area, and taxing the electricity generated as that water is released. This double taxation is inequitable and should be explicitly prohibited.

B. Coal. Coal should be treated as a "feedstock" where it is used to produce another fuel, such as through coal gasification. The Administration's program should exempt from taxation this "feedstock" and impose the Btu tax only on the Btu content of the fuel produced.

C. Nuclear. The Administration's proposal imputes a heat rate for nuclear power plants that is in fact higher than the national average heat rate for such plants, resulting in a higher tax on nuclear power. The Department of Energy's Energy Information Administration tabulates on an annual basis the average heat rate for all domestic nuclear power plants. That annual figure should be used for assessing the Btu tax for all nuclear generation.

D. Imported Energy. In taxing imported electricity and natural gas, the tax rate assessed should not alter the competitive position of imported versus domestic sources of energy, nor should it alter the mix of fuels.

E. "Unconventional Fuels." Electricity generated from unconventional fuels such as wind, solar, biomass and geothermal are exempt from the Btu tax. This exemption is designed to help these fuels become economically viable and should be continued only until they achieve such viability. Once a determination has been made that these exempted fuels are commercial, then the tax exemption should be removed. The definition of unconventional fuels should be expanded to include such things as extraction and combustion of methane from landfills, the use of

tire-derived fuels, and solid waste-to-energy projects.

1. Renewable Energy Incentive Section 1212 of the Energy Policy Act of 1992 (Public Law 102-486) contained a program authorizing the payment of 1.5 cents per kWh to consumer-owned utility developers of various qualifying renewable energy projects. Funding of this provision is consistent with the purpose of the exemption of such fuels from the Btu tax, is necessary to achieve parity with the tax credit provided to investor-owned utilities, and should be provided for in the budget to be submitted for the Department of Energy.

F. Stockpiles. If stockpiles are to be taxed, care must be taken to ensure that it does not result in double taxation as the fuel is used to generate power. Similarly, if the stockpile of one fossil fuel is taxed, then all fossil fuel inventories must be taxed. Stockpiled uranium, of course, needn't be taxed in any case since the Btu tax is to be imposed on the electricity generated by nuclear power plants rather than the fuel. Since inventories have yet to generate revenue for their owners, collection of the tax on stockpiles should be spread over time so as not to create an unreasonable burden on cash flow.

IV. PROVISIONS AFFECTING FEDERAL POWER MARKETING ADMINISTRATIONS

APPA reaffirms its support for cost-based rates for electricity marketed by the federal power marketing administrations (PMAs) and its opposition to changes in the repayment practices of the PMAs. APPA opposes the provisions of the Administration's economic package that would reduce net outlays for the PMAs by $100 million annually beginning in FY 1996 and that would authorize "market incentives" for energy conservation by PMA customers. Federal power customers will share in paying the Btu tax on power marketed by the PMAs; it is unfair to levy additional costs on these systems. The energy conservation market incentive program is fraught with workability problems and violates the principle that federal power should be distributed at cost-based rates.

The proposal levies a surcharge per acre-foot on water sales by Reclamation projects. However, irrigators are required to repay their capital costs of these Reclamation projects only to the extent of their financial ability; those capital costs beyond the ability of irrigators to repay ultimately are repaid by power customers. Any surcharge legislation and subsequent implementing regulations must specify that this water surcharge shall not increase power customers' repayment obligations.

Any Btu tax that is levied on PMA electricity production should be charged proportionally to all beneficiaries of federal power. Thus, the tax should be applied to PMA power distributed to federal agencies and to project power utilized for irrigation features of Reclamation projects. Again, care must be taken in drafting the legislation and implementing regulations to insure that none of these costs are ultimately transferred to the repayment obligation of power customers due to irrigators' limited ability to pay.

V. OTHER PROVISIONS OF CONCERN TO PUBLIC POWER

The Administration's proposal must be accompanied by other provisions that will promote economic development, protect consumers from the regressive nature of the Btu tax, and encourage various energy efficiency technologies. They include:

- the elimination of the $15 million private-use restriction placed solely on public power (Section 141 (b)(4) of Title 26 of the Internal Revenue Code);

- the inclusion of tax-exempt bond simplification provisions contained in H.R. 13, the Tax Simplification Act of 1993, introduced recently by Chairman Rostenkowski, along with additional tax-exempt bond simplification provisions passed twice last year in H.R. 4210, the Tax Fairness and Economic Growth Act of 1992 and H.R. 11 the Revenue Act of 1992, but vetoed by President Bush. (This would include provisions to increase from $10 million to $25 million the amount banks can deduct and further simplify arbitrage rebate requirements.); and

- full funding for Section 1212 of the Energy Policy Act of 1992 (Public Law 102-486), which provides for an incentive payment program for qualifying renewable energy facilities developed by consumer-owned utilities.

In addition, deficit reduction and increased public and private sector efficiencies can be advanced by efforts designed to make the government more efficient. The Administration must concentrate on cost-cutting efforts, as well as reducing regulatory lag and taking steps to ensure better coordination and cooperation between federal agencies.

Lastly, APPA supports a number of energy and consumer assistance programs already contained in the Administration's economic package, including in particular the following: energy conservation and efficiency projects, particularly those supporting research, demonstration and commercialization of electric vehicles; joint ventures in support of research, demonstration and commercialization of renewable energy and energy efficiency; magnetic levitation and high-speed rail transportation; accelerating the development of a nationwide broadband, interactive telecommunications network; reducing the backlog of critical operation and maintenance items at Corps of Engineers and Bureau of Reclamation projects; and providing additional job training and retraining.

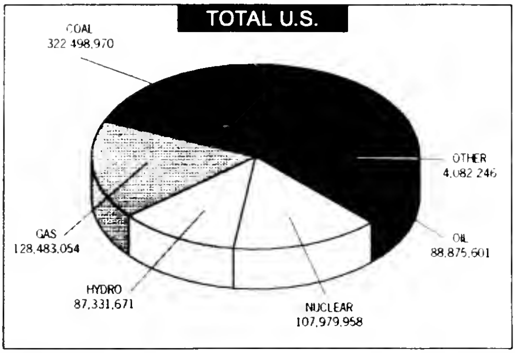
Number of State and Local Publicly Owned Electric Utilities, By State, 1991

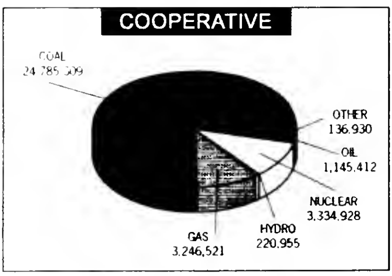
Figures include operating joint action agencies

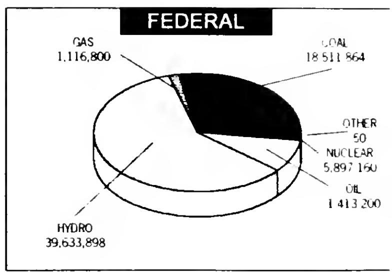
Alabama	37	Nebraska	159
Alaska	39	Nevada	8
American Samoa	1	New Hampshire	5
Arizona	25	New Jersey	9
Arkansas	15	New Mexico	7
California	46	New York	50
Colorado	32	North Carolina	75
Connecticut	7	North Dakota	11
Delaware	9	Ohio	85
Florida	35	Oklahoma	65
Georgia	53	Oregon	17
Guam	1	Pennsylvania	34
Idaho	11	Puerto Rico	1
Illinois	42	Rhode Island	1
Indiana	73	South Carolina	23
Iowa	138	South Dakota	36
Kansas	123	Tennessee	63
Kentucky	29	Texas	80
Louisiana	23	Utah	43
Maine	5	Vermont	16
Maryland	5	Virgin Islands	1
Massachusetts	42	Virginia	16
Michigan	43	Washington	43
Minnesota	129	West Virginia	2
Mississippi	24	Wisconsin	83
Missouri	91	Wyoming	14
Montana	1	**Total**	**2,026**

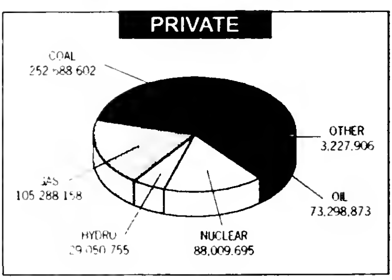
U.S. Electric Utility Generating Capacity, 1991

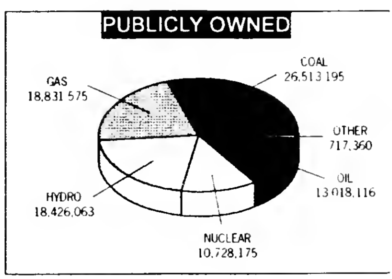
NAMEPLATE CAPACITY IN KILOWATTS. NUMBERS REFLECT JOINT OWNERSHIP AND INCLUDE PUERTO RICO.











20 Largest State & Local Publicly Owned Electric Systems

ELECTRIC CUSTOMERS SERVED - 1991 (Ultimate customers served.)

1	Los Angeles Department of Water and Power	1 368 282
2	Puerto Rico Electric Power Authority	1 171 548
3	Salt River Project Phoenix Arizona	539 190
4	San Antonio City Public Service. Texas	473 955
5	Sacramento Municipal Utility District. California	460 564
6	Memphis Light Gas and Water Division. Tennessee	356 794
7	Seattle City Light Washington	331 451
8	Jacksonville Electric Authority Florida	295 407
9	Nashville Electric Service Tennessee	275 811
10	Austin Utilities Texas	273 449
11	Omaha Public Power District. Nebraska	252 422
12	Public Utility District No 1 of Snohomish County Washington	211 367
13	Orlando Utilities Commission. Florida	156 785
14	Knoxville Utilities. Tennessee	150 548
15	Colorado Springs Utilities. Colorado	145 567
16	Chattanooga Electric Power Board. Tennessee	142 302
17	Tacoma City Light. Washington	130 225
18	Huntsville Utilities Alabama	109 133
19	Clark Public Utilities Washington	106 679
20	Nebraska Public Power District	106 231

ELECTRIC REVENUES - 1991 (Revenues from sales to ultimate customers and from sales for resale)

1	Los Angeles Department of Water and Power	$1.771 026 000
2	Puerto Rico Electric Power Authority	1 198 836 000
3	New York Power Authority	1 166 426 000
4	Salt River Project. Phoenix. Arizona	1 134 687 000
5	San Antonio City Public Service. Texas	672 471 000
6	Sacramento Municipal Utility District. California	661 658 000
7	Memphis Light. Gas and Water Division. Tennessee	624 622 000
8	Jacksonville Electric Authority. Florida	567 411 000
9	Intermountain Power Agency. Utah	565 687 000
10	South Carolina Public Service Authority (Santee Cooper)	557 736 000
11	Municipal Electric Authority of Georgia	550 637 000
12	Nashville Electric Service. Tennessee	530 996 000
13	Nebraska Public Power District	466 272 000
14	Washington Public Power Supply System	440 905 000
15	North Carolina Municipal Power Agency	438 810.000
16	Austin Utilities. Texas	415 492 000
17	Omaha Public Power District. Nebraska	376 588.000
18	North Carolina Eastern Municipal Power Agency	370.749 000
19	Lower Colorado River Authority. Texas	323 808 000
20	Seattle City Light Washington	280 945.000

KILOWATT-HOUR SALES - 1991 (Sales to ultimate customers and sales for resale)

1	New York Power Authority	36 232 028.000
2	Los Angeles Department of Water and Power	21 520 788 000
3	Salt River Project. Phoenix. Arizona	17 563 423 000
4	South Carolina Public Service Authority (Santee Cooper)	13 597 271 000
5	Puerto Rico Electric Power Authority	13 283 229 000
6	Nebraska Public Power District	13.061.140 000
7	San Antonio City Public Service. Texas	12.021 153 000
8	Public Utility District No 1 of Chelan County. Washington	11 540 046 000
9	Memphis Light. Gas and Water Division. Tennessee	11.451 827 000
10	Intermountain Power Agency. Utah	10.750 184 000
11	Nashville Electric Service. Tennessee	9 912 965 000
12	Public Utility District No 2 of Grant County Washington	9 903.037 000
13	Municipal Electric Authority of Georgia	9 310 838 000
14	Seattle City Light. Washington	8 832 638 000
15	Jacksonville Electric Authority Florida	8 693 944 000
16	Sacramento Municipal Utility District. California	8 421 441 000
17	North Carolina Municipal Power Agency	8 022 722 000
18	Lower Colorado River Authority Texas	8 005 311 000
19	Omaha Public Power District. Nebraska	6 859 187 000
20	Austin Utilities Texas	6 826 815 000

U.S. Electric Utility Statistics

Statistics for publicly owned systems, private systems, cooperative systems and federal systems are based on Energy Information Administration Forms EIA-860 and EIA-861. Some adjustments have been made by APPA.

Number of Utilities	1991
Publicly owned systems*	2 014
Private power companies	264
Cooperative systems	947
Federal power agencies**	10
TOTAL	3 235

*Reflects only those utilities which file Form EIA-861 with the Energy Information Administration
**Includes Alaska Power Administration Bonneville Power Administration Southeastern Power Administration Southwestern Power Administration Western Area Power Administration Tennessee Valley Authority U S Army Corps of Engineers Bureau of Reclamation Bureau of Indian Affairs and International Boundary and Water Commission For additional information on federal systems see page 153

Number of Ultimate customers	1991	Percent
Publicly owned systems	16 565.893	14 6%
Private	84 973.561	75 0%
Cooperatives	11.706 776	10 4%
Federal	29.700	0 0%
TOTAL	113.275.930	100 0%

Kilowatt-Hour Sales To Ultimate Customers (in millions of kWh)	1991	Percent
Publicly owned systems	408.385	14 7%
Private	2.110.528	76 0%
Cooperatives	204.921	7 4%
Federal	52.944	1 9%
TOTAL	2.776.778	100 0%

Electric Revenues from Sales to Ultimate Customers (in thousands of dollars)	1991	Percent
Publicly owned systems	24 503.583	13 1%
Private	147.582.567	78 6%
Cooperatives	14 139 825	7 5%
Federal	1.479.079	0 8%
TOTAL	187.705.054	100 0%

Installed Capacity (in thousands of kilowatts)	1991	Percent
Publicly owned systems	88.234	11 9%
Private	551.564	74 6%
Cooperatives	32.880	4 5%
Federal	66.573	9 0%
TOTAL	739.251	100 0%

Note installed capacity includes adjustments for joint ownership Data reflect utilities that file Form EIA-860 plus Puerto Rico Electric Power Authority

Data reflect capacity at start of calendar year

Kilowatt-Hour Generation (in millions of kWh)	1991	Percent
Publicly owned systems	320.017	11.2%
Private	2.121.827	74 4%
Cooperatives	156.405	5 5%
Federal	253.829	8.9%
TOTAL	2.852.078	100.0%

Mr. ANDREWS. I just have a couple of questions. Mr. Williamson. Assume for a moment that the Congress and the President have decided that there is going to be taxes in the deficit reduction package, and assume further that there is to be an energy component in the package.

I understand your opposition to Btu tax. Is there another energy tax that you would suggest that would make up the $70 billion loss that would be taken away from the package if we don't have a Btu tax?

Mr. WILLIAMSON. The difficulty with an energy tax is it is not broad-based. There are not very many producers in the Nation. Unfortunately, Texas is the No. 1 producer of natural gas and the No. 1 producer of oil and about the fourth or fifth largest producer of coal. That is not broad-based. So what you would need to do is to touch the most people who use energy, and that is, obviously, not through the production taxes.

Mr. ANDREWS. Well, would a gasoline excise tax be more preferable?

Mr. WILLIAMSON. I am sorry?

Mr. ANDREWS. Would a gasoline excise tax be more preferable?

Mr. WILLIAMSON. It would be tremendously more fair, a more broad-based tax.

Mr. ANDREWS. And how so?

Mr. WILLIAMSON. It hits the consumer of gasoline. If you are trying to identify and to lower the consumption of energy in the Nation, in addition to raising funds, then you must attack the transportation problem. Two-thirds of all the oil used in this country goes into gasoline, into motor fuels on our highways. That is more oil than we produce in the country.

Mr. ANDREWS. Now, relative to the Btu tax, there is much disagreement, as I know you are aware, of where the tax should be collected. What are your thoughts about this? How do we achieve the goal you just suggested of a broad-based tax? Where should the tax be collected?

Mr. WILLIAMSON. Well, I think if you are going to tax natural gas—one of the things that we are trying to do is promote natural gas as a clean burning fuel, a fuel of choice for the future—you want to pass that tax as far along as you can to as many of the taxpayers out there as possible.

Natural gas is currently selling about $1.70, $1.80. This time last year it was at a $1. So the volatility—it is the most volatile price, the most volatile commodity on the exchange over last year. The price volatility is a problem. Twenty-seven cents an MCF is a big chunk out of that, and if you put that on the producer, you will shut in natural gas. You will not see production of natural gas.

So I would encourage that if you have to tax, to put it on the utility bill. Itemize it on the utility bill.

Mr. ANDREWS. Mr. Mitchell, you testified that you wanted to see the consumer pay that tax; is that correct?

Mr. MITCHELL. Yes, Mr. Chairman, that is the only way it can happen.

Mr. ANDREWS. Mr. Nagel says that will create inequities in the market place and will discourage fuel efficiency. How do you respond to that?

Mr. MITCHELL. All right. I think if Mr. Nagel and I can agree that what we are after is looking for the protection of the consumer, and the customer—we both want in the regulatory process.

The suggestion that if it were imposed as a line item, or otherwise as an excise tax item, would impair the State's ability to regulate that item, I think it is probably not exactly the way we would look at it.

Mr. ANDREWS. Excuse me, how do you mean it would impair the State's ability to regulate?

Mr. MITCHELL. The proposition, of course, is that if the Government were to say impose the tax, a line item on the bill, the last bill, that the local commissions would not have an opportunity to consider the overall prudency of the total utility's expenditures.

That, I don't think, is quite correct. I don't know any commission in this Nation that can either of its own volition within 24 hours begin a case against any utility to look at any of its cost, how it is collected—and that would deal with taxes or anything else. So that can be done.

In the event the commission were to decide not to do it at the instant that the tax is imposed, they could surely pick it up routinely in any future rate case. So the State bodies would have an opportunity to still continue the prudency review, which they have now over all utility costs.

Mr. ANDREWS. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman. Let me try to summarize in my own mind very quickly what you gentlemen have said.

Mr. Mitchell has said we should not have an energy tax but a value added tax. Mr. Kanner has said certainly we should not do what we are proposing to do. Actually, the tax should be lower. Mr. Nagel has said no, but we would like to work with the administration. Mr. Williamson said no, but if done it should be a consumer-based tax, and then Mr. Fry said, OK, but only for deficit reduction and with certain other provisions.

You see, the hard thing for somebody like myself is to sit and listen to you, gentlemen, and try to put this thing in proportion. I happen to believe that, in general, you are right. We should not have an energy tax, because we are trying to take money out of the system which in theory will help grow us out of this recession. However, at the same time, everyone says—and I guess I am to blame a bit myself—we all support the President's goals but we don't agree with the means. And so one of you gentlemen, I think it was Mr. Williamson, said that we want to balance the budget in Washington but not on the backs of the hardworking men and women.

Well, you know, that is a wonderful statement to make, and I used to sit down there where you are sitting and I used to say the same things, but the problem is we have to fix this deficit because it is increasing our debt to the point where we are going to be suffocated. So if we do not handle something like this extremely essential part of our economy, how do we go about this task and what part does your industry play? Are we just going to put it on the

backs of the consumers? Are we going to say this is just a value-added tax, an add-on, a substitute?

Specifically, what does your industry and your client tell you to help us solve our combined problems?

Mr. MITCHELL. Congressman, let me touch on that in one way. The proposition of the Btu tax is fatally flawed when you look at it in its conceptual state. What the attempt is, as I understand it, is to impose on energy, which is only 8 percent of the gross domestic product, about 27 percent of all the tax increases that has been suggested is needed.

On the surface of it, that raises a huge question of unfairness. Why not go to a broad-based consumption, spread it over as much of the population, in all services as we can possibly do, lower the hit on any single use, and help the country remain competitive?

As far as the VAT tax, I think, my own personal opinion, and in the face of the experts, I understand I am being rather presumptuous here, but my own opinion is that the value added tax is a thing whose time has come.

We are in a situation now where Boeing produces a 747, and we are going to throw all these taxes on it, by the way, somewhere in the process, and tries to sell it overseas, maybe in competition with the Airbus or something. When it gets to Europe, the value added tax is added onto that airplane. When Airbus sends a plane here, the tax is taken off. And yet the system we are proposing here will tax the American products and not put anything on the import. It simply is not the way to go, practically or logically.

In our business, we are spending a huge amount of money for efficiency in this country. My own little tiny company is spending $250 million over 5 years strictly on conservation and efficiency. That amount of money, it is huge. Furthermore, we face, as an industry, something like $5 billion a year to take care of the Clean Air Act requirements. All of these things being imposed simultaneously is going to strangle and hurt, ultimately, the American consumer, because they have to pay the rates.

Mr. HOUGHTON. Let me interrupt a minute because I see the red light is on and we don't have any more time. But, you know, you say something which is very meaningful. You are saying it is unfairly loading a portion of the tax burden on you, and you are an important segment of the whole economic uplift of this country.

But the consumer can also say the reason the economy increases is because of consumer spending. And what you are doing is you are unfairly loading an extra part of that tax burden on us. So that is the question we are wrestling with.

Mr. Chairman, my time is up and I am sorry I have not been able to get to the other gentlemen. I thank you very much for your participation.

Mr. ANDREWS. Mr. Kleczka.

Mr. KLECZKA. No questions, Mr. Chairman.

Mr. ANDREWS. Mr. Bunning.

Mr. BUNNING. Thank you.

Mr. Nagel, in your testimony you talked about collection points and where we should initiate these collection points. Can you tell me that downstream is a better area to collect them than at the place where they are produced? Is that your opinion?

Mr. NAGEL. No, we favor upstream collection as opposed to downstream collection, and let me tell you why. There is only one tax that I know that is collected on an excise tax basis and that is the telephone excise tax, and you see that on your telephone bill. But energy and fuel cost is simply one component of an overall cost of producing electricity and natural gas and delivering it to the ultimate customer.

Those costs are rolled all together in a utility rate case and considered as a unit. We don't take out one item and say let us treat that specially and put it as a line item on a utility bill. And that is why we favor, in terms of energy efficiency and energy conservation opportunities, there are great opportunities available in the production and generation of electricity, in the production and distribution of natural gas. By having taxes collected at the beginning of the process, we encourage energy efficiency throughout the process.

Mr. BUNNING. But that's in direct contrast to what Mr. Mitchell said. That narrowly punishes or it narrowly defends who you collect the tax from. In other words, if we think taxing is the way we can reduce the deficit, and I surely don't, the more people that we can include in paying that tax, the better off we would be, the more fair we would be in our Tax Code.

Mr. NAGEL. If the assumption can be relied on that all producers are treated alike, that all production units, that all generation units are imposed the same tax, then assuming an efficient market, which I think we have to accept in this country, then all will be treated in the same way and they will all have the same opportunities to flow it downstream.

Mr. BUNNING. I am not going to dispute that, but the fact of the matter is that in Iowa, your rate and your public service commission might differ from mine in Kentucky or Texas, or wherever it might be, and in consideration of each individual rate case, there may be different facts and figures brought in. So, therefore, it would be more difficult to do it that way fairly.

Mr. NAGEL. Keep in mind, as I said in my testimony, 38 of the States have a separate mechanism for passing through these costs automatically. Even in the 12 States that use general rate cases or specific proceedings, there will be consideration.

There is an underlying concern I think that has to be acknowledged and on the table. This is not the time when utilities want to come in for rate cases. We have the lowest interest rates we have had in 20 years right now. They don't want to have their rates on the table. We have to acknowledge that fact, that this is not a year they want to come in for a rate case.

Mr. BUNNING. Let me ask a basic question, and anybody can pick it up. What effect will the energy tax have on job creation and economic growth? Do you think it would depress the economy rather than assist the economy? Generally, anybody who wants to take a shot at that.

Mr. WILLIAMSON. The energy tax will harm the people who produce the energy and that will decrease jobs, lose jobs. These are high paying jobs. In my State, I have indicated we have lost 170,000 jobs in 10 years. That is more than any other industry in

a particular State that I know of. This will increase that load and it will hurt the marginal production of——

Mr. BUNNING. Does everyone believe, as I do, that it will have a major ripple effect into everything we produce in the United States?

Mr. WILLIAMSON. We are competitive because we have quality control. Houston Industries, as I mentioned, or Cooper Industries, as I mentioned in my testimony, produces valves. I toured their plant the other day. They had valves going to Russia and they were painted red. They had valves going to Indonesia and they had valves going to Ecuador. They showed me an instrument about this big that measures that valve accuracy within one-millionth of an inch.

We are very good at manufacturing and we are very good at competing, but when we put a surcharge on that particular item that no other country has, then we have to compete and we have to eat that surcharge, and we will not be as competitive with our foreign competitors. That is the way it works.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. ANDREWS. Mr. Payne.

Mr. PAYNE. Thank you very much, Mr. Chairman. And thank all of you, gentlemen, for coming and testifying before us today. It has been very, very helpful.

Mr. Nagel, I wanted to follow up on a question that Mr. Bunning just asked to make sure I understand your response.

As you talked about upstreaming the tax, you stated that one of the purposes of doing that was to optimize energy conservation. However, it seems to me in a market economy, to optimize energy conservation you want the tax where the energy decision is being made, which is at the consumer level.

Could you explain that a little more so that I can understand it?

Mr. NAGEL. There are two types of energy efficiency or energy conservation; demand-side, which you have just addressed on the customer side, where the higher the price of the fuel, they should pursue more energy efficient options, and I understand that completely.

But on the supply side, before it gets to the customer, there are tremendous energy efficiency opportunities. Cutting your loss of electric generation during the transmission of electricity. Tremendous gains can be made there. In choosing your fuel mix and optimizing your fuel mix, you will choose your fuel better if some fuels turn out to be more costly or less effective than others.

And in terms of pursuing renewable energy resources, if some of those are exempted from this tax, such as solar or wind, we will have a better effort there.

So in terms of both energy efficiency on the supply side and pursuing renewable energy resources, we believe upstream collection is more preferable than downstream collection.

Mr. PAYNE. Preferable in that you will optimize conservation?

Mr. NAGEL. A utility or a producer will be indifferent to pursuing energy efficiency on the supply side if the tax is not collected there because it will simply have no impact on them. It would solely be on the customer side.

Mr. PAYNE. Mr. Mitchell, you mentioned at the conclusion of your testimony, after you had stated all the concerns about this tax, that if there were to be such a tax, it should be an excise tax. Do you see that as being an ad valorem tax or a Btu-related excise tax?

Mr. MITCHELL. It can be related back to Btu and then converted into a cost per kilowatt hour without any difficulty at all. And that would be imposed right at the tail end of the bill. Whether it is spelled out or not is immaterial and irrelevant. If someone thinks a customer will not know it, of course, they have their head in the sand.

The reason for doing it there, another major reason, which maybe I didn't make clear, if you put it on at the source, at the Btu when the coal comes into the plant or is produced, you have automatically added on to that end result the gross receipts tax. So as the example I gave you, in our case, 76 million because of the Btu tax, and by the time it rolls through the gross receipts tax, takes it up to 80 million. So that is unavoidable and there is not much we can do about that.

So that is another reason for putting it in the proper place and that is where the decision is made for energy, for the selection of energy use.

Mr. PAYNE. So you are saying that in terms of the purity of this particular tax, if you correct it at the end without adding additional taxation along the way, it is a better approach than adding it at the production end?

Mr. MITCHELL. Yes, sir, and much better for our customers.

Mr. PAYNE. Thank you very much. I will yield back the balance of my time.

Mr. ANDREWS. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Fry, you said one of your association's conditions for support of an energy tax is that the increased revenue be applied to the deficit. Is there anything in the President's proposal which makes you think the increased revenues will, in fact, be applied to the deficit?

Mr. FRY. Our concern is the revenues not be earmarked up front for any purposes other than deficit reduction. We would propose that any spending proposals, even including those which we support, go through the normal appropriations process and be judged on their merits.

Mr. MCCRERY. So your only objection is that the increased revenues not be earmarked for some specific new spending?

Mr. FRY. That is correct.

Mr. MCCRERY. You don't mind if there is increased spending generally, just don't earmark it?

Mr. FRY. If spending can be justified on its merits, and as you will notice in our statement, we do support some increased spending. For example, increased appropriations for the LIHEAP program. But we would not propose that those revenues come from any earmarking of the Btu tax.

Mr. MCCRERY. Mr. Nagel, if you hide the tax from the consumer, which is basically what you are proposing to do, are you not concerned that it would be easier for the Congress to increase the tax,

and, at some point, doesn't that tax become burdensome on your industry?

Mr. NAGEL. Sir, I would tell you that taxes are but one component of many components that go into the cost of a kilowatt hour. And we do not attempt to break down for customers' knowledge all of the components of a cost of a kilowatt hour or an MCF of gas.

The tax elements change routinely. We see changes in the corporate tax rate proposed in the current package, and that will certainly flow through the process at some point in time. We see State income taxes changed. We see property taxes changed. We do not attempt to itemize those on the bills.

In fact, again, the only taxes I know that are itemized on bills today is a Federal excise tax on the telephone and the State sales tax which is found in most States. I would see no reason why we would want to break this one out and bring it on to the bill specifically any more than any of the other tax items that are part of the overall cost of fuel and electricity and gas.

Mr. MCCRERY. So you don't think that by not doing that that you are hiding the tax from the consumer?

Mr. NAGEL. I guess I would not accept that description of it any more than we would be supposedly hiding property taxes, income taxes, and any of those other sort of taxes.

Mr. MCCRERY. Well, except that, as Mr. Williamson has suggested, this is a targeted tax; it is not a broad-based property tax or income tax. It is an energy tax that relates specifically to your industry, rather than when people pay their electric bill. I would think they would want to know what part of that is due to taxes.

They know what their property taxes are and their income taxes are, why should they not know what their energy taxes are?

Mr. NAGEL. It goes back to the issue, sir, of the fact that, again, it is simply one component of an overall package of costs that go to produce a kilowatt hour of electricity.

If you were to review a general rate case proceeding and see the elements that make up a revenue requirement for a utility, I think you would be amazed at the complexity of those numbers. And there would be a number of customers, if we attempted to describe with specificity all the items that go into making up the cost of a kilowatt hour, who I think would say, no thanks, we don't want to hear those details.

Mr. MCCRERY. Does anyone on the panel disagree with Mr. Nagel?

Mr. WILLIAMSON. Oh, yes, I disagree. Dennis has been after me for 3 months to join NARUC, and I see I need to join that council so we can have these discussions.

We had a rate case yesterday, Monday, and we were discussing passing on a salary increase. A man was going to make $30,000, and we were going to decide whether that was reasonable or not. It was a 60-percent increase over last year. So we discussed that issue. We do break these charges down and discuss them and talk about them.

I think the bottom line, and the most important fact in this particular tax, if we are going to have it, is to make it broad-based. That is what the President's proposal and goals were, to make it as broad as we can over all the population. This does not do that.

But to decide whether or not we need to hide it from the consumer, I don't know if putting the tax on the bill is hiding it or not hiding it, but I do know people I talk to around the State when we talk about the Btu, they think they are taxing the British. So that is a concern.

Energy is a very complex issue, and if you put it on the producer, then the consumer does not know about it. And that is what we have regulators for to do our jobs. I am elected by the people to do my job, and if I vote for increases, then I have to stand the heat. If you think it is necessary, then you stand the heat. If you vote for this tax, you are going to have to stand the heat and that is why we are elected.

Mr. MCCRERY. Thank you very much.

Mr. ANDREWS. Mr. Brewster.

Mr. BREWSTER. Thank you.

As one who is from an energy State, I have many serious concerns about an energy tax. As Mr. Williamson knows, our people drive a heck of a lot more than they do in some parts.

You each made some statements that were interesting, and some I concur with. Three of you mentioned the deficit should solely be controlled by cuts. I wish that were possible. As one who is certainly supporting additional cuts, I wish we could get there. But if you look at it, we only control about 16 percent of the budget today. The other 84 percent are entitlements, defense, and interest.

When interest is consuming 14 percent of this year's budget, it makes it rather difficult to get there strictly by cuts. If you eliminate all the domestic spending, which is agriculture, education, transportation, HUD, and veterans, et cetera, you realize you still would not eliminate the deficit.

So it comes to the point that we have to make serious cuts and, yes, we have to raise some revenue. I was interested, Barry, in hearing you say that you felt an excise tax on gasoline was better than the Btu tax. I certainly see that as narrow-based rather than broad-based. And why not let some of the others have some of the joys of helping pay for it, as far as the utility industry or chemical industry or whatever?

I would hope, Mr. Nagel, if the collection point is somewhere other than burner tip on natural gas, or say a refinery exit for oil, that you and the regulating industry would figure a full passthrough. I am curious how you would do that.

Mr. NAGEL. As I mentioned, 38 of the States have automatic passthrough systems for fuel cost. In Iowa, for instance, all elements of fuel, including taxes, are adjusted monthly and there would be an automatic pickup of these costs in our State under other current rules. So as Iowa utility would not have the concerns that were expressed earlier.

Twelve of the States do not have those systems. They rely on some alternative method, either specific proceedings to address the issues specifically, or wait for a general rate case. And that is the question of regulatory lag that sometimes you hear about.

For those utilities, they will either say we have to come in right now and file a rate case proceeding to incorporate this tax into our costs, or they may say, there are other factors affecting our cost, such as lower interest rates, whatever, and we can stay out for a

while longer and simply absorb this cost because other costs are going down while this cost is going up.

Mr. BREWSTER. How do you plug that in on nuclear, hydropower, solar, wind, whatever?

Mr. NAGEL. Again, in Iowa, in our fuel clause, it is indifferent as to what type of fuel it is. It is still automatically included. The utility simply submits its fuel bills to us for review and that tax would simply be incorporated as part of that calculation.

Mr. BREWSTER. So you would calculate a cost into the nuclear cost?

Mr. NAGEL. As I understand the administration's proposal, there is a Btu equivalent or uranium and that is added to the cost and that would be included in the bill paid by the utilities securing the fuel.

Mr. BREWSTER. Another thing interesting to me, Mr. Fry mentioned there that they were very interested in economic development, protecting consumers, et cetera. I would like you to explain your suggestion to eliminate the $15 million private use restriction on public power. Short explanation, if possible.

Mr. FRY. This restriction was imposed by the 1986 Tax Reform Act, and prior to 1986, up to 25 percent of facilities constructed through the issuance of tax-exempt bonds could be used for the benefit of private parties. For all Government bonds, this restriction was reduced to 10 percent by the 1986 act. However, for public power and public natural gas systems, generation and transmission facilities only, a further limitation was imposed. The private use test was the lesser of 10 percent or $15 million.

There were neither fiscal nor public policy justifications for the $15 million private use test imposed only on public power. While limiting private use of public financed facilities from 25 percent to a somewhat lower amount was the subject of congressional debate, the $15 million limitation was never expressly discussed and the limitation was not imposed for fiscal reasons, and there was no revenue estimate ever made of that limitation.

We believe it discriminates against communities that elect to provide their own electric and gas utility services, and may force local government developers of electric generating and transmitting facilities to forego the most economic use of those facilities, particularly in the early years of their service.

They tend to be long-lived capital-intensive facilities, and it is customary in the business to construct facilities that have capacity somewhat in excess of present needs so that you can grow into them. And yet, because of declining unit costs of the output of these facilities, you have the most economic scaled facility and can provide the lowest cost to the ultimate consumers.

If you are artificially prohibited from building a facility of the optimum size, that increases the cost to your consumers. So we don't think there was any fiscal basis for this, no revenue estimate was ever made, and we think it discriminates against public power systems and should be repealed.

Mr. BREWSTER. Thank you.

Mr. ANDREWS. Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Gentlemen, I appreciate your testimony and the input you have given us. When I first saw the Btu tax, I thought it was a proposal whose time should never come. And you, gentlemen, have articulated very, very well the points I have been making publicly ever since I first heard about it.

I asked several of the administration witnesses the question, do you know of any other country in the world that taxes its raw energy, and I would like to ask you the same question.

Mr. MITCHELL. I don't, Mr. Archer. I do know that in some countries there is a rather heavy tax on gasoline.

Mr. ARCHER. That is very different. That is very different.

Mr. MITCHELL. That is correct.

Mr. ARCHER. That just confirms what I believe to be the facts. Is there not a good reason why no other country taxes its raw energy? And shouldn't we stop and pause for a moment and begin to ask the question why don't they tax their raw energy?

And you have given us the answer to that. It is going to drive our jobs overseas. It is a job creator—in other countries. No question about it. But the Secretary of the Treasury sat here as a witness and said, well, it will only increase the aluminum companies' cost of product by 3 percent. Well, Alcoa says it would be 6 to 8 percent.

He also said there would be no exemption for aluminum on the cost of electricity in their proposal. And I would submit that 3 percent in a high volume, low-margin product that is almost a virtual fungible commodity in the world marketplace is enough, even if it is only 3 percent, to severely damage that industry.

So I thank you for your testimony, and it is very supportive of the argument that I have made.

Thank you, Mr. Chairman.

Mr. ANDREWS. Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman.

We all said we support the President, that we are with the President, but not on this particular issue, Mr. President. As Members of Congress, we have a mandate to reduce the deficit, raise revenue, stimulate the economy.

Mr. Mitchell, do you have any particular revenue-raising proposals that you think are fair; that are just and right, in addition to the VAT tax?

Mr. MITCHELL. I think, Congressman, that the value-added tax imposed properly with due regard for the low-income, with due regard for those who are pressed, is the only tax that is needed in this country today to take care of its problems.

Mr. LEWIS. Other members of the panel care to react?

Do you have something better to offer; something better to put on the table in order to cut the deficit and get necessary revenue to stimulate the economy?

Mr. WILLIAMSON. I think, Mr. Lewis, that in order to stimulate the economy, that you would not tax. Because if you do tax, you do just exactly the opposite of stimulating the economy. The way to raise revenue is to grow the economy, and it is a broader base and you can collect your tax that you already have in place.

I would encourage you to look strongly at some of the proposals on the table. I know that Congress negotiated, 2 years ago, spend-

ing caps, and I would encourage you to look strongly at those. We paid over $100 billion for those spending caps. I would encourage you to look at those and come back in a year.

This economy is starting to grow. I know it is in Texas.

Mr. FRY. Mr. Lewis, our association has not attempted to craft the ideal tax. We are responding to the tax on the table and we are willing to accept the Btu tax. We have some concerns about the details of it, but we recognize the need that something be done; we recognize our responsibility to participate in the solution, and hence, we are open to the suggestion of an energy tax of some kind.

In my statement, I have detailed some of our concerns about the particulars of the Btu tax. As I say, we have not—we don't suggest that the Btu tax is the ideal tax but it is the one before us and we think it could be made workable.

Mr. LEWIS. Well, the President suggested in his statement to the Congress and to the American people that we all are in this thing together; that we are all in the same boat and we all must pay our fair share. So I don't think any of us are going to escape without paying something. We may not get all that we pay for, but we are going to pay for all we get.

Thank you, Mr. Chairman.

Mr. ANDREWS. Ms. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

It is interesting that in the President's budget, this tax will raise $70 billion, but because it is going to have such a significant impact on people by raising their costs, the President has increased the EITC $25 billion specifically to offset the impact of this tax, which tells you something about the impact it will have on small business, too.

He has increased food stamp spending and the LIHEAP Fuel Assistance Program by $15 billion, for a total of $40 billion, all to offset the impact of this tax on low-income families in America; leaving, therefore, a net increase in revenue to the Federal Government of only $25 billion. For which, it appears to me we are going to pay, from your testimony, dearly in the competitiveness of American manufacturing.

As my colleague from Texas just pointed out, no other nation taxes the energy that fuels manufacturing and the kind of production that we have to be No. 1 in to compete internationally. I think we should take that very, very seriously.

It is also true, is it not, that cogenerators, self-generators, could easily evade this tax? Self-generators are often big businesses, again putting little businesses that compete with them at a competitive disadvantage because they cannot circumvent the tax. I am particularly concerned about the fact the tax would hit hydro projects so heavily that the tax would be larger than their revenues.

The very entrepreneurial efforts that this government has paid to create in solar and hydro and renewable resources are going to be devastated by this, at least that is my understanding. If it is not yours, I would like to know it.

Now, specifically, because I would like to know your comments on the impact on solar and those kinds of entrepreneurial projects, but also what percent of America's homeowners depend on home

heating oil, which will be taxed twice as heavily as any other fuel source; and what percentage of those homes have no access to an alternate fuel, gas or any other?

What percentage of our industry relies on oil to drive its work; what percentage of small business relies on oil; and what percentage of those businesses that rely on oil have no alternate source?

I hope you are experts in the delivery of energy and have the knowledge depth that we need to evaluate the impact of this tax on both the small business community and the individual homeowner in America, both of whom are important to the strength of our society and the vitality of our economy.

Mr. NAGEL. Madam Congresswoman, let me suggest to you there are, in response to your question about solar and hydro projects, as I understand the administration's proposal, they would not be taxed at all. They would be exempted to encourage the development of renewable energy resources.

Second, in terms of the alternatives available to the users, especially the small residential customer in Iowa, and I can only speak to the Iowa circumstance, I am not familiar with the nationwide statistics, 12 percent of our residential homes do not have access to natural gas. They are located primarily either in farms or outside communities where the natural gas lines do not reach. They either use fuel oil or propane to heat their homes. Those are the choices available to them.

Inside the communities, typically, even though they have options available to them, they do not have realistic options because their homes are equipped for only one or the other. And it is unlike large industrial customers, they do not have the capacity to switch back and forth.

Mrs. JOHNSON. Do you know what percentage have no switch capacity?

Mr. NAGEL. I would say, other than the large manufacturing customers in Iowa, virtually nobody has alternative fuel capacity. All residential homes in many of the cities basically are hooked up to the natural gas systems, and outside the cities, in the rural areas and the farms, they are hooked up either to fuel oil or propane.

Mr. WILLIAMSON. Mrs. Johnson, my numbers are a couple years old, but I remember that about 3 percent of electric generation comes from petroleum; 60 percent of electric generation comes from coal, natural gas makes up in the 20's, and solar, nuclear, wind and hydro garners the last part of that share. But the Northeast uses about 50 percent of generated electricity from oil, and most of that is imported oil.

Mrs. JOHNSON. Of course, one of the additional problems with the Northeast is what we don't use from oil, we get from nuclear, and nuclear is very heavily disadvantaged under this proposal.

But I would say, Mr. Nagel, that, apparently, the hydro industry does not agree with you they are not being taxed in this proposal, in fact, they believe they are being taxed as heavily as coal, and that is why they say they will literally be put out of business.

Mr. NAGEL. I want to distinguish solar and wind from hydro. Solar and wind are exempted, hydro is not exempted. I would not like to leave that impression with you.

Mr. ANDREWS. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Gentlemen, welcome, and thank you for your very good testimony.

I am new to the committee and what I have figured out in the last couple of months is that really the best tax is the one where we tax the other guy. And the best idea in that vein has been to tax the British this morning. After all, they did burn down our Capitol and the White House, and they have never paid us back, so I guess the bill is due.

The President has said it is time to reduce the deficit and to generate jobs, and we have to work out the details on this. There is great benefit, you must admit, in terms of reducing the deficit, just in terms of reducing your cost of capital as well, and so you are going to have a savings at that rate as well.

The Secretary of the Treasury came in here and testified about the tax, energy tax, and said there are three reasons: Energy efficiency, environmental concerns, revenue raising measure. I would also say, in terms of the oil issue, for example, that in terms of our national defense, we really ought to be encouraging policies to move away from our dependence on oil, particularly foreign oil.

I want to hit the issue on energy efficiency, and from the Northwest, of course, we believe that hydro does a very good job in this area.

Mr. Kanner, do you happen to know, your testimony says hydro is about 90 percent efficient, and do you happen to know the efficiency ratings on gas and oil and nuclear?

Mr. KANNER. Most of the fossil fuel plants, and there are obviously different technologies, are in the 30- to 35-percent efficiency range.

Mr. KOPETSKI. Anybody disagree with that?

So hydro is being taxed at the same rate as nuclear and higher than natural gas, under the President's proposal?

Mr. KANNER. Under the proposal, the assumption is a kilowatt hour of electricity generated with hydro is as if it were generated from burning coal or natural gas.

Mr. KOPETSKI. So we can make the case, for those of us who rely on hydro, and it is not just the Northwest, that under this criteria we ought to change the policy, at least be to the natural gas level, or if not lower in terms of energy efficiency?

Mr. KANNER. I think that is right. If you are saying let's tax fuels based on their ability to create energy, then the numbers for hydro need to be fixed. And as my testimony says, this can be done without either doing damage to the objective of regional equity or without substantially reducing the revenue that this tax would generate.

Mr. KOPETSKI. Let us talk about energy as a feedstock for production. In the oil industry it is my understanding they don't have an exemption under the President's plan. There is a strong movement, and I think the Secretary has been open to allowing oil that is used as a feedstock, for example in the plastics industry, to be exempt from the tax; is that correct?

Mr. KANNER. Yes.

Mr. WILLIAMSON. I don't have the proposal. I am not aware of that. I know there are discussions going on. One of the questions

is whether or not the fuel used to run the refinery will be excluded or included.

Mr. KOPETSKI. I think the Secretary was very open to that discussion, but when it came to the aluminum industries, though, where it is the same policy question, the Secretary had a pretty firmly shut door.

Mr. Kanner, can you talk a little more about the significance of feedstock for the aluminum industry?

Mr. KANNER. Certainly.

The cost of electricity is about a third of the total cost of producing the finished product for the aluminum industry. The aluminum industry in the Northwest employs about 10,000 workers. Right now the cost of electricity is about 20 percent higher than the world average; and any increase in rates will increase that margin; decrease their competitiveness.

I would note the reason the aluminum industry has stayed in the Northwest was Bonneville adopted a variable rate in 1985. At the same time, aluminum plants in the Tennessee Valley shutdown because of their competitive position worldwide.

I would also note that in the Northwest there are other industries with similar energy-intensive characteristics. Chemical products are in the 25- to 35-percent range. Paper is 7 to 20 percent. Even Boeing, which is only about 1 percent, when you factor in the fact that their costs are kept down by the fact that they are so close to the source for aluminum products, what happens to aluminum ultimately affects Boeing which, as you know, recently laid off 27,000 workers.

Mr. KOPETSKI. Right. And let me jump in at this point, because I am running out of time. I guess the President about 3 or 4 weeks ago criticized Europe in terms of their subsidies for Airbus in the aerospace industry, and one of our competitive industries is Boeing, which, obviously, uses a lot of the aluminum. Two weeks later what the President is doing is imposing another tax on this industry he is trying to protect here at home.

Finally, let me just point out what the Federal Government is doing under Federal laws in the Endangered Species Act, whether because of timber or fish stock issues, that we in the Northwest have spent, I think it is about $1 billion addressing this issue just through our rate base from Bonneville Power to fund these environmental issues. Isn't that correct as well?

Mr. KANNER. We have already spent $1.3 billion on fish mitigation and enhancement, and we are going to spend at least $300 million a year for the foreseeable future.

Mr. KOPETSKI. That is in our electric rate base?

Mr. KANNER. That is right.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Excellent testimony, Mr. Kanner.

Mr. ANDREWS. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

I wonder if one of you gentlemen can tell me whether there has been any estimates on the cost to industry to comply with a brandnew tax? In other words, we are talking about what, I think, Congresswoman Johnson describes as a net to the Government of someplace in the neighborhood of $25 million.

Now, how much money is it going to cost industry, that is going to come off their bottom line, to comply with this new tax?

Mr. MITCHELL. The best estimate we have is that the total cost that is going, or the total revenues that will be raised from energy tax alone is going to be somewhere around $22 billion, something on that order, and that is putting $22 billion of increased taxes on 8 percent of the gross domestic product, which energy is. That is one of the fundamental problems.

As to the cost to the electric utilities, that will be somewhat different throughout the Nation. Parts of that $27 billion, we are looking at about $8 billion to the electric utility customers; about $8 billion. That is about as easy a breakdown, I think, as I can give.

One thing for sure, we will never recover all the costs that are imposed. That is just not doable.

Mr. HANCOCK. Actually, what I had reference to is primarily the cost of additional employees; you know, keeping the books. How many Government employees are we going to need to come around and make an audit, and how much of your staff time, your employee time, is going to be spent keeping track?

In other words, the compliance cost of an awful lot of these taxes actually ends up costing industry more than the amount of money the Government ends up with in net revenues. That was the estimate I was looking for.

Mr. MITCHELL. That is true, sir. I don't think our industry has ever attempted to make that calculation. It would be very significant.

Mr. HANCOCK. You are probably afraid to. If those figures ever came out, there would be a bunch of these taxes we would probably get rid of because of the compliance cost.

You know, the statement was made earlier in this hearing about Secretary Bentsen stating that the energy tax would create someplace in the neighborhood of a 2- to 3-percent increase in the price of aluminum, and he didn't think that was particularly severe.

What is your opinion on a 2- to 3-percent increase in the price of electricity or anything else?

Mr. MITCHELL. Well, sir, if it were only 2 to 3 percent, that might be one question. However, it is not going to be 2 or 3 percent. What we are looking at on the residential customer throughout the Nation, it is somewhere between 3.5 to 4 percent. By the time we impose all of the taxes onto industry and commercial activities, we are going to see rates in some industries in excess of 10 percent, I think. Overall average, roughly, 5, 5.5 percent, before you throw in all of the piggyback taxes that will likely hit all of the consumers.

So the difficulty in dealing with all of these proposals is all the facts are hardly ever there that you can really pull them out and add them up. That is part of the problem.

Mr. HANCOCK. Then there is really nothing inflationary about this tax?

Mr. MITCHELL. This tax is going to be the ultimate of inflationary. Not only that, it is indexed, of course, into the future years, and that is going to increase the disparity between the various regions of the country and between the various industries.

Mr. HANCOCK. Well, in other words, I kind of get the idea you think maybe there might be a better way than a Btu tax. It would appear to me, even though I am not going to vote for any tax increase, that maybe we should use the existing structure; and if we have to, even though I will vote against it, raise an existing tax, which does not increase the cost of compliance, rather than come up with a brandnew tax, whether or not we call it a Btu tax.

Mr. MITCHELL. I wouldn't know what existing tax would be proposed to be raised. The income tax increase proposal is a source of real concern. When you make that thing retroactive, that is the same as the government putting its hands right straight into the pockets of every shareholder of every utility in the country and taking money out that they will never get back. That is exactly what that does. So whatever tax we would increase, I don't know.

Mr. ANDREWS. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I want to go to part of your testimony, Mr. Mitchell. In your testimony, you said that conservation was a cost being imposed on the utilities. I would like you to explain to me why energy conservation is a cost rather than an opportunity. In the Northwest we view it as a way to reduce the cost of additional construction.

Mr. MITCHELL. Certainly, that was not the intent to indicate that conservation is something that the industry is opposed to, because we are not. I think that, overall, it is to the benefit of every consumer in this Nation that the utility industry push conservation as much as it economically and reasonably can; where it is cost beneficial and efficient to do so.

If we counter that in terms of efficiency, that really benefits everybody. That means powerplants we don't have to build. Unfortunately, it is not free. Conservation costs money; it is not free. We are going to spend $250 million for the next 5 years on conservation in this area right here, and we expect to save over 58 percent of all of the growth that would otherwise be imposed on us to the year 2002.

So we are spending huge sums of capital in order to help in the conservation activities. And that is true around the country. There are over 2,000 conservation programs in effect.

Mr. MCDERMOTT. I suspect you would be supportive of a bill we put in directing the Internal Revenue Service to create that, or treat that as an expense in a given year rather than to be amortized over 30 years, that cost of conservation that you are going to do?

Mr. MITCHELL. I think that each State commission is reviewing and making its own consideration of that. We have worked out in our local agencies here, local commissions, an acceptable way of amortizing the cost, including a return on the investment for conservation.

Now, each State, I think, will probably approach that a little differently.

Mr. MCDERMOTT. I want to move to Mr. Kanner for the whole question of the Northwest, and I suppose we all get regional. I think Tip O'Neill said all politics is local.

Everyone thinks of the Northwest as full of rain and so forth. What are the conditions for this year in terms of water and what

that means in terms of our ability to sell power to southern California?

Mr. KANNER. As you know very well, we have been in, I believe it is the fourth year of successive droughts. Water conditions are at a historical low, and much of the water that there is is being held for increased flows for fish migration, for threatened and endangered species. So this has resulted in substantial rate increases.

The initial proposal of the Bonneville Power Administration for a rate increase was, roughly, 15 percent. Actually, 11.4, and then increased to 15 percent. Based on the most recent precipitation figures, they have increased that figure to 27 percent. So already there is a 12-percent increase that is going to occur just because of weather conditions. It is both because water needs to be held back for fish, reduced short-term energy sales to California, increases to power purchase cost.

As you know, this condition is not going to stop with this year. The estimates are that in 1994, there will be another 10 percent rate increase, and in the 1995, during the next rate case, there will be at least another 10 percent rate increase. You can add these up all together and within 3 years we are looking at a 60-percent rate increase in the region.

Mr. MCDERMOTT. Let me ask a question of Mr. Fry, and that has to do with this whole question of the double taxation over hydroelectric pump storage; can you talk about that? Give us an understanding of what that double taxation really is.

Mr. FRY. The pump storage projects produce about 3 percent of our Nation's electricity, and the way they work is the base load plant will be used in the off-peak hours to pump water uphill to a storage reservoir. During the hours of peak demand, that water will be released to power turbines to generate electricity. This is a very efficient use.

The base load plant is going to be spinning 24 hours a day, so the cost of electricity used to pump the water uphill is really the fuel cost of the base load plant. But by so doing, you get this very flexible peaking unit that can provide cheap energy during the hours of peak use.

Our concern is that since hydroelectricity is taxed at the utility level—and the fuel for many base load plants, and typically in a pump storage plant it would be a nuclear plant or a coal-fired plant; let us take coal because it is a clear-cut example—if the coal has been taxed at the mine mouth, you have already paid the tax for that; then you burn that coal to generate electricity to run your pumps to get the water uphill so you can generate hydroelectricity coming down, and then the hydropower is again taxed.

So the hydropower would be taxed twice, and we think that is unwise. We would like to see the proposal modified so that it takes into account the unique character of pump storage facilities and imposes the tax only once.

Mr. MCDERMOTT. Where is that 3 percent of the pump storage facilities?

Mr. FRY. I cannot give you the distribution of those plants offhand. Obviously, since it is such a small proportion of the national generating base, in some areas where there is a large pump storage

plant, the impact would be much greater than it would be nationally.

Mr. McDERMOTT. I would appreciate a copy if you could give us a distribution of that.

Mr. FRY. Be happy to do that.

[The information follows:]

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Pumped Storage at its Peak: A Status Report

With more than 40 new pumped-storage projects being planned in the U.S., existing capacity has the potential to double. To succeed, developers must address technical, environmental, and power market issues.

By Christopher Hocker

The world's largest pumped-storage facility, Bath County, is owned by Virginia Electric and Power Company and Allegheny Power System. Its six pump-turbines can generate 2,100 MW of capacity. Planning for the project began 20 years ago; the units began operating in December 1985. (Courtesy Virginia Power)

Today, interest in hydroelectric pumped storage on the part of public agencies, utilities, and private developers in the U.S. is higher than it has been for 30 years. Major reasons for the pumped-storage revival include both its potential as an economical source of peaking power and its demonstrated capability as a tool for managing and improving the efficiency of utility system operations.

"We are highly optimistic about the future prospects of pumped storage in the U.S.," says Bjorn Omreng, president of Kvaerner Hydro Power, Inc., a leading manufacturer of pump-turbine equipment used in pumped-storage facilities. "An increasing number of utilities have begun to express a strong interest in the new generation of pump-turbine technology, and how its operating benefits can add to their systems. The advancing technology allows for a much wider range of applications and benefits than merely generation and energy storage." Kvaerner is actively involved in supporting several major pumped-storage projects in the U.S., including the proposed 2,000-MW Mt. Hope project in New Jersey.

Analyzing current interest and future prospects for U.S. pumped storage reveals some apparent paradoxes:

—Pumped storage has been a viable technology for more than 70 years, yet the vast majority of operating projects in the U.S. are less than 25 years old.

—Every operating pumped-storage project in the U.S. is owned either by a public agency or an investor-owned utility, yet three-quarters of the projects currently being planned are sponsored by private non-utility companies.

—Pumped-storage development in the U.S. has primarily emphasized its role as a provider of peaking capacity, yet the technology's "dynamic operating benefits" (those benefits that enable the utility's overall power system to operate more reliably and efficiently) may prove to be of equal or greater value.

Reviewing the history of U.S. pumped storage in its proper context helps to resolve these apparent paradoxes. Just as the nation's methods of generating and delivering electric power have evolved over time, so have the technology and applications for pumped storage.

Chris Hocker is vice president of communications for Consolidated Pumped Storage, Inc. and is a frequent free-lance contributor to Hydro Review.

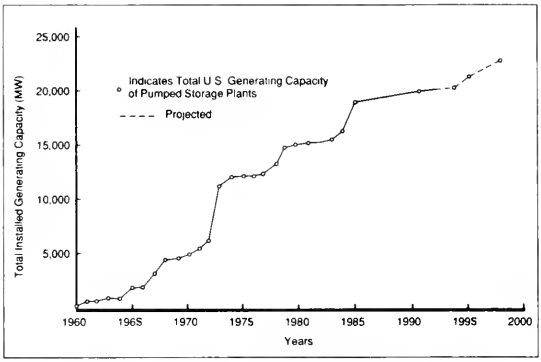

Figure 1: This line graph shows the actual and projected growth in U.S. pumped-storage capacity from 1960 through 2000 (Data courtesy of the Federal Energy Regulatory Commission, March 1992, and the American Society of Civil Engineers/Electric Power Research Institute *Civil Engineering Guidelines for Planning and Designing Hydroelectric Developments: Volume 5.*)

A Look at the History Of Pumped Storage

Today's operating total of approximately 18,000 MW of pumped-storage capacity in the U.S. started almost literally with a drop in a bucket. The first pumped-storage plant in the U.S.—Rocky River in Connecticut—as completed in 1929 with only 7 MW of pumping capacity. The project, owned by Connecticut Light and Power, is still in operation.

Pumped storage had its boom period in the 1960s and 1970s, with nearly 30 plants completed during these two decades. These plants represent nearly three-quarters of the pumped-storage capacity currently operating. They included two of the largest pumped-storage projects in the world: Ludington in Michigan (1,979 MW), completed in 1973 by Consumers Power Company and Detroit Edison; and Raccoon Mountain in Tennessee (1,530 MW), completed in 1979 by the Tennessee Valley Authority.

The 1980s saw the completion of three additional projects, including Bath County in Virginia (2,100 MW), completed in 1985 by Virginia Electric and Power Company and Allegheny Power System. The Bath County Project is the world's largest operating pumped-storage project in terms of capacity.

Thus far in the 1990s, one pumped-storage project has been completed—the 1,000-MW Bad Creek Project in South Carolina, built by Duke Power Company. The 675-MW Rocky Mountain Project in Georgia, jointly owned by Oglethorpe Power Corporation and Georgia Power Company, is under construction and scheduled for completion by the mid-1990s.

In addition, in April 1991, Summit Energy Storage, Inc., a subsidiary of Consolidated Hydro, Inc., received a license from the Federal Energy Regulatory Commission (FERC) for its 1,500-MW Summit Project in Ohio. Although construction has not yet begun on this project, it is scheduled for completion in the late 1990s. Summit is the first pumped-storage project developed by a private, non-utility company to hold a FERC license.

The U.S. Army Corps of Engineers has begun mechanical testing of the first of four pump-turbines installed at Richard B. Russell Dam, in northeast Georgia near Calhoun Falls, South Carolina. A 1989 court ruling permitted the Corps to install but not run the reversible units pending resolution of a lawsuit by fish and wildlife interests. The Corps spent $8 million to study potential effects of pumped storage on fisheries and water quality and $1.5 million on research, development, and installation of sound and light fish deterrent systems. The new units, which should all be commissioned by mid-1992, will add 360 MW to the 300 MW of the project's four conventional turbines. The testing period is to run for one year after the last unit goes on line.

Timely completion of the Rocky Mountain and Summit projects and the court approval to operate the Russell pump-turbines would bring the number of pumped-storage projects built in the U.S. to 38 by the end of the century, with a total capacity of approximately 20,700 MW. Figure 1 depicts the increase both in number and cumulative capacity of U.S. pumped-storage projects from 1960 through 2000.

The average capacity of pumped storage also has increased significantly over time, from less than 300 MW in the 1960s to nearly 870 MW scheduled for the 1990s. Figure 2 shows the decade-by-decade trend in average plant capacity.

Technology Changes

Important developments in pumped-storage technology help to explain both the increased number of pumped-storage facilities and their larger average size. Prior to World War II, plants existed primarily in Europe and South America. They involved relatively small machines (under 100 MW capacity, with most much smaller), and frequently operated in conjunction with a conventional hydroelectric plant. The first U.S. project, Rocky River, was a typical example. This 1929 plant had two 3.5-MW reversible pump-turbines operating together with 24 MW of conventional capacity.

Pump-turbine manufacturers gained valuable experience with larger, higher-head European and South American projects during the 1930s. This set the stage for development of a reliable single-stage reversible Francis-type pump-turbine, which, in turn, allowed larger, more economical installations.

During the 1950s and 1960s, U.S. and European trends in pumped-storage technology began to diverge based on different operating philosophies. European operators placed a high value on the ability of pumped storage to provide system stability and frequency control, in addition to peak power generation. To maintain fre-

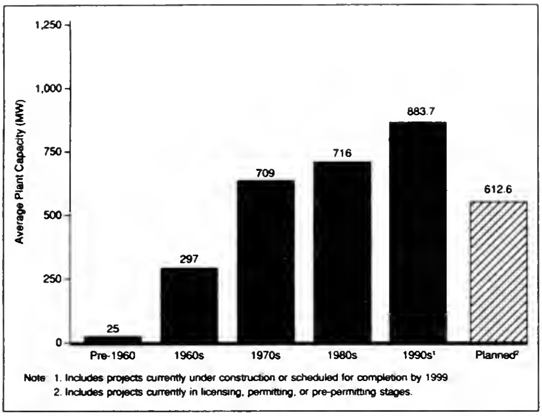

Figure 2: This bar graph shows the average capacity of U.S. pumped-storage facilities from pre-1960 through the year 2000 and beyond. (Data courtesy Federal Energy Regulatory Commission, March 1992, and the American Society of Civil Engineers/Electric Power Research Institute *Civil Engineering Guidelines for Planning and Designing Hydroelectric Developments: Volume 5.*)

quency control, the plant must be capable of following load fluctuations almost instantaneously and to change from pumping to generating modes very rapidly. To meet this need, pumped-storage installations in Europe frequently include separate pumps and turbines combined with motor-generators. In this configuration, both the pumps and turbines rotate in the same direction.

Significant costs are incurred in exchange for the potential advantages of separate pumps and turbines. These costs have not been attractive to project planners in the U.S. who, in contrast to the Europeans, have tended to place primary value on economical generation to meet peaking needs rather than frequency control. Therefore, U.S. developers of pumped-storage plants have continued to favor single-stage reversible pump-turbine installations, which have reduced construction and equipment costs at the sacrifice of some operating flexibility and efficiency. Nonetheless, this type of installation also offers substantial benefits, such as frequency control, voltage regulation, and a significant source of reserve power to replace unscheduled outages in other parts of a utility's generating system.

Both in the U.S. and other countries, the historic trend has been toward increasingly large projects in terms of pumping and generating capacity. There is evidence, however, that this trend may level off. Although average pumped-storage project size has increased to approximately 884 MW (see Figure 2), the average capacity of 42 U.S. plants now in the planning or licensing stage is approximately 600 MW.

In addition, a consensus appears to exist among engineers and operators that pumped-storage installations with two or more individual units each in the 200 MW to 300 MW size range provide optimum operating reliability for a typical utility system.

Future Plans

Judging by FERC's list of pumped-storage projects currently in the licensing or permitting stages, overall interest in the technology in the U.S. may be at an all-time peak. If all of these projects were actually to come on line, they would approximately double today's total both of projects installed (42) and combined capacity (25,709 MW).

FERC license applications are pending for three large projects, all of which, like the Summit project, are being developed by independent companies. The 2,000-MW Mt. Hope Project in New Jersey has been the subject of a detailed Environmental Impact Statement (EIS) prepared by FERC staff, which recommended licensing. The 1,000-MW Rocky Point Project in Colorado recently began the EIS process. And the 600-MW River Mountain Project in Arkansas is awaiting the commencement of the EIS process.

A total of 25 projects representing nearly 14,000 MW are currently being studied under FERC preliminary permits, of which only five are sponsored by public agencies or utilities. The largest of these is the 2,500-MW Dominguez Project on the Gunnison River in Colorado. Other sizeable permitted projects include Abert Rim (2,000 MW), Russell Canyon (1,000 MW), and Lorella (1,000 MW), all in Oregon; Dry Fork (1,000 MW) in Wyoming; and Reed Hill (1,000 MW) in New York.

Twelve pumped-storage projects representing more than 4,800 MW currently have preliminary permits pending. Eight of the projects on this list are sponsored by independent developers. The largest of this group are two 1,000-MW projects in Oregon, Langell Valley and Bryant Mountain.

Western states dominate the geographic distribution of projects now being studied, with only six of the 37 projects in the permitting or pre-permitting stage located east of the Mississippi River. Of the western projects, eight are in California, six in Oregon, and five in Arizona.

Independents Dominate

Independent developers are directly responsible for 31 of the 40 pumped-storage projects in the planning (licensing, permitting, or pre-permitting) stage. Several developers are involved in more than one project:

—Consolidated Hydro, Inc., through subsidiaries and affiliates, is planning three pumped-storage projects that are in various stages of the licensing process;

—Independent Hydro Developers of Scottsdale, Arizona, an owner of conventional hydro projects, holds preliminary permits or permit applications for at least six projects;

—Gentry Resources Corporation, also of Arizona, has applied for permits on five projects; and

—Creamer and Noble Energy, Inc., an engineering firm in St. George, Utah, holds permits on three projects.

Table 1: Pumped-Storage Plants Operating in the U.S.

Project Name and FERC License Number, if applicable	*Capacity (MW)*	*Owner/Operator*	*State*	*Year In Service*
Bad Creek, 2740	1,000.0	Duke Power Company	South Carolina	1991
Balsam Meadow, 67	200 0	Southern California Edison	California	1987
Bath County, 2716	2,100.0	Virginia Electric and Power Company/ Allegheny Power System	Virginia	1985
Bear Swamp, 2669	600.0	New England Power Company	Massachusetts	1974
Blenheim Gilboa, 2685	1,000 0	New York Power Authority	New York	1973
Cabin Creek, 2351	300.0	Public Service Company of Colorado	Colorado	1967
Carters Dam (two reversible units)	250 0	U.S. Army Corps of Engineers	Georgia	1975
Castaic, 2426	1,275.0	California Department of Water Resources/ Los Angeles Department of Water and Power	California	1973
Clarence Cannon (one reversible unit)	31.0	U.S. Army Corps of Engineers	Missouri	1983
DeGray (one reversible unit)	28 0	U.S. Army Corps of Engineers	Arkansas	1969
Edward G Hyatt, 2100	293.2	California Department of Water Resources	California	1968
Fairfield, 1894	511.2	South Carolina Electric and Gas Company	South Carolina	1976
Flatiron 3	8 5	Bureau of Reclamation	Colorado	1954
Grand Coulee Pump Generation	314 0	Bureau of Reclamation	Washington	1974
Helms, 2735	1,053.0	Pacific Gas and Electric Company	California	1984
Hiwassee (one reversible unit)	59.5	Tennessee Valley Authority	North Carolina	1956
Horse Mesa	99 9	Salt River Project	Arizona	1972
Jocassee, 2503	610.0	Duke Power Company	South Carolina	1973
Lewiston, 2216	240 0	New York Power Authority	New York	1961
Ludington, 2680	1,978.8	Consumers Power Company/Detroit Edison	Michigan	1973
Mormon Flat	48 6	Salt River Project	Arizona	1971
Mt. Elbert	200.0	Bureau of Reclamation	Colorado	1981
Muddy Run, 2355	880.0	Philadelphia Electric Power Company	Pennsylvania	1967
Northfield Mountain, 2485	1,080.0	Northeast Utilities Service Company	Massachusetts	1973
O'Neill	25.2	Bureau of Reclamation	California	1967
Raccoon Mountain	1,530 0	Tennessee Valley Authority	Tennessee	1979
Rocky River, 2576	7 0	Connecticut Light and Power Company	Connecticut	1929
Salina, 2524	259 8	Grand River Dam Authority	Oklahoma	1968
San Luis	424 0	Bureau of Reclamation	California	1968
Seneca (Kinzua), 2280	425.7	Pennsylvania Electric Company/ Cleveland Electric Illuminating Company	Pennsylvania	1970
Smith Mountain, 2210	247.4	Appalachian Power Company	Virginia	1965
Taum Sauk, 2277	408.0	Union Electric Company	Missouri	1963
Thermalito, 2100	82.5	California Department of Water Resources	California	1968
Wallace Dam (Laurens), 2413	216.0	Georgia Power Company	Georgia	1978
Yards Creek, 2309	386.0	Jersey Central Power and Light Company/ Public Service Electric and Gas	New Jersey	1965

Note Data used in this table came from the Federal Energy Regulatory Commission and the American Society of Civil Engineers/Electric Power Research Institute *Civil Engineering Guidelines for Planning and Designing Hydroelectric Developments: Volume 5*

Another private company, Peak Power Corporation of San Francisco, California, holds a preliminary permit on one project, the 100-MW Butte project in Montana, and, as of March 1992, had applied for a permit on a second. The company is developing other 100-MW scale projects that avoid using navigable waterways. Peak Power's design, trademarked as Modular Pumped Storage, uses standardized components and man-made reservoirs charged with ground water or wastewater.

Perhaps surprisingly, investor-owned utilities (IOUs), which operate 17 of the existing pumped-storage projects in the U.S., are involved in only two of the projects currently being planned. Of the 13 projects not sponsored by independent developers listed in Table 2, eight are planned by municipal or regional publicly owned utilities, two by IOUs, two by federal agencies, and one by a rural electric cooperative.

The rise of independent developers in pumped storage and the decline of IOU involvement appear to be related phenomena. In many states, the regulatory environment discourages IOUs from planning large new power plant projects, especially those which, like pumped storage, are capital-intensive and require long lead times for development. Many independents, however, perceive these circumstances as an opportunity. They appear willing to bear the development and construction risks of pumped storage—risks that IOUs are unwilling or unable to take—in the expectation that IOUs will become a market when the power from their projects becomes available around the beginning of the next century.

Issues in Development Of Pumped Storage

Although the current wave of renewed interest in pumped storage is encouraging, there are no guarantees that projects now being planned will actually be built. To be successful, today's group of developers must address significant issues, some of which have become of far greater concern than during the previous pumped-storage boom of the 1960s and 1970s.

Technical Aspects

Assuring that a project is technically sound is always a key concern, particularly if technical problems increase costs to an unacceptable level. Proper siting, of course, is essential. Apart from environmental concerns that may exist, the site must provide sufficient vertical distance between the upper and lower reservoirs for economical energy generation. It also must permit a relatively short distance between the generation equipment and the intake/outlet facility at the lower reservoir, to minimize costs of tunneling and excavation. Subsurface rock must

This photograph of the Northfield Mountain pumped-storage project shows the upper reservoir in the foreground and the Connecticut River (used as lower reservoir) in the upper middle of the picture. Northeast Utilities Service Company built the 1,000-MW project in the early 1970s, during pumped storage's boom period. The project was uprated to 1,080 MW in 1989. (Courtesy Northeast Utilities)

be competent for the construction of underground powerhouse facilities, tunnels, and shafts.

Transmission access is another important technical issue. An otherwise ideal site may become unfeasible if project development requires extensive new transmission lines and related facilities.

Environmental Concerns

With the possible exception of some off-stream plants, proposed pumped-storage projects, like conventional hydro projects, require a license from FERC. Under rules made during the 1980s, FERC must give equal consideration to environmental issues *and* energy issues during its review of a license application. Due to the large size of most pumped-storage projects, developers are likely to encounter many significant environmental issues to be resolved in the licensing process. These include such potential effects as entrainment of fish in the intake; changes in water use and quality resulting from fluctuations in the lower reservoir; visual disturbance resulting from creation of a large upper reservoir; and construction-related effects such as dust, traffic, and noise.

Experienced developers have found that careful early planning and a proactive approach to the concerns of resource agencies are essential in addressing and resolving environmental issues.[1] But even with a sound approach and a manageable level of environmental concerns, developers can expect requirements for lengthy, detailed environmental studies to precisely define environmental effects and needed mitigation measures.

In an effort to avoid potential environmental obstacles, some developers are taking a close look at "off-stream" pumped-storage configurations that do not use natural streams or lakes as a water supply source. The Summit and Mt. Hope projects for example, are designed to use deep underground caverns as lower reservoirs. Upper reservoirs will be constructed on the ground surface, with water purchased from municipal or other public sources for initial fill-up and replenishment of evaporation.

The off-stream concept need not necessarily require an underground cavern. Projects such as those planned by Peak Power Corporation involve small surface reservoirs constructed in arid regions of the U.S., with no natural water supply. At least four off-stream pumped-storage projects are currently in the permitting or pre-permitting stages.

Need for Power

Based on forecasts of additional energy needs in the U.S. over the next ten to 20 years, it appears reasonable to expect an increasing demand for peaking power and other benefits of pumped storage. Independent developers currently expect their projects to help meet this new demand, and intend to market power from these projects to public and investor-owned utilities on a wholesale basis.

Political and regulatory considerations may disrupt this scenario, however. Environmental and consumer advocacy groups recently have become strong proponents of energy conservation and other demand-side management (DSM) measures as alternatives to proposed new power plants, regardless of their technical, environmental, or economic merits. In many states, agencies responsible for regulating utilities also are encouraging DSM and questioning the need for large new projects. In this climate, a developer may encounter difficulty in justifying a pumped-storage project to the public and state regulators, even if it has obtained a FERC license.

Developers may be able to address this issue by emphasizing the compatibility of pumped storage with DSM goals. In addition to generating peak power, pumped storage improves the overall efficiency of a utility system by leveling out the "peaks and valleys" in the utility's daily load demand curve. Enhancing system efficiency in this way can help meet major DSM goals such as reducing energy consumption, reducing air pollution from fossil-fueled plants (especially older facilities), and promoting opportunities for cost savings that can be passed along to ratepayers.

Pumped-Storage Prospects

With interest in pumped storage at a high point in the U.S., those involved in its planning, design, and promotion are considering ways to enhance its prospects for future success. One such approach is to place greater emphasis on pumped storage as a management tool, rather than as simply a source of peaking power. "Storage helps utilities manage energy in the same way that hub airports manage passenger flow for airlines," says Jim Birk, PhD, director of the Storage and Renewables Department of the Electric Power Research Insti-

Table 2: U.S. Pumped-Storage Plants under Construction or in the Planning Stages

Project Name and FERC License Number, if applicable	*Proposed Capacity (MW)*	*Developer*	*State*	*Status*
Abert Rim, 10875	2,000	Abert Rim Hydroelectric Company	OR	Holds FERC Preliminary Permit
Blue Diamond North, 10758	100	Blue Diamond North Pumped Storage Power	NV	Holds FERC Preliminary Permit
Blue Diamond South, 10756	100	Blue Diamond South Pumped Storage Power	NV	Holds FERC Preliminary Permit
Bryant Mountain, 10982	1,000	Bryant Mountain Hydroelectric Associates	OR	Awaiting FERC Preliminary Permit
Butte, 11201	100	Peak Power Corporation	MT	Holds FERC Preliminary Permit
Crystal Creek, 10847	500	Creamer and Noble Energy Inc.	CA	Holds FERC Preliminary Permit
Cuffs Run, 10868	849	Mid Atlantic Energy Inc.	PA	Holds FERC Preliminary Permit
Davis, 2709	1,000	Monongahela Power Company	WV	Holds FERC License/License being appealed by Sierra Club, Corps denied Section 404 permit
Dominguez, 11176	2,500	Dominguez Hydroelectric Associates	CO	Holds FERC Preliminary Permit
Dry Fork, 10725	1,000	Little Horn Energy Wyoming Inc.	WY	Holds FERC Preliminary Permit
Eagle Mountain, 11080	500	Eagle Mountain Energy Company	CA	Holds FERC Preliminary Permit
Garden Bar, 11164	290	South Sutter Water District	CA	Holds FERC Preliminary Permit
Gregory County	2,360	U.S. Army Corps of Engineers	SD	Corps continues feasibility studies/ difficulties with upfront financing
Indian Spring, 7825	250	Gentry Resources Corporation	AZ	Awaiting FERC Preliminary Permit
Iowa Mill, 11092	400	Sacramento Municipal Utility District	CA	Awaiting FERC Preliminary Permit
Lake Pleasant, 10467	800	Gentry Resources Corporation	AZ	Awaiting FERC Preliminary Permit
Langell Valley, 10971	1,000	Russell Canyon Corporation	OR	Awaiting FERC Preliminary Permit
Lorella, 11181	1,000	Energy Storage Partners	OR	Holds FERC Preliminary Permit
Mississippi Valley, 10941	500	Southern Minnesota Municipal Power Agency	MN	Holds FERC Preliminary Permit
Mt. Hope, 9401	2,000	Halecrest Company	NJ	Awaiting FERC License
New Jones Fork, 11092	400	Sacramento Municipal Utility District	CA	Awaiting FERC Preliminary Permit
Parkman, 10725	7	Little Horn Energy Wyoming Inc.	WY	Holds FERC Preliminary Permit
Pickens, 10436	900	Oglethorpe Power Corporation	GA	Holds FERC Preliminary Permit
Rattlesnake Hill, 11119	5	Rattlesnake Hill Developers	NH	Holds FERC Preliminary Permit
Red Rock, 11095	200	Greenwood Pumped Storage Corporation	IA	Holds FERC Preliminary Permit
Reed Hill, 11152	1,000	Clinton Pumped Storage Corporation	NY	Holds FERC Preliminary Permit
Richard B. Russell (four reversible units)	360	U.S. Army Corps of Engineers	GA	Mechanical Testing of 4 Pump-Turbines
River Mountain, 10455	600	JDJ Energy Company	AR	Awaiting FERC License
Rocky Mountain, 2725	675	Georgia Power Company and Oglethorpe Power Corporation	GA	Holds FERC License/Under Construction
Rocky Point, 7802	1,000	Natural Energy Resources Company	CO	Awaiting FERC License
Russell Canyon, 10897	1,000	Russell Canyon Corporation	OR	Holds FERC Preliminary Permit
Saguara, 7826	250	Gentry Resources Corporation	AZ	Awaiting FERC Preliminary Permit
Spring Creek, 10990	104	City of Redding, California	CA	Holds FERC Preliminary Permit
Stukel Mountain, 11136	750	Russell Canyon Corporation	OR	Holds FERC Preliminary Permit
Summit, 9423	1,500	Summit Energy Storage, Inc.	OH	Holds FERC License
Taffner, 10725	20	Little Horn Energy Wyoming Inc.	WY	Holds FERC Preliminary Permit
Tonto Pumped Storage, 7463	150	Gentry Resources Corporation	AZ	Awaiting FERC Preliminary Permit
Tropicana, 11221	100	Peak Power Corporation	NV	Awaiting FERC Preliminary Permit
Upper Gunnison, 11038	60	County of Arapahoe, Colorado	CO	Awaiting FERC Preliminary Permit
Vineyard, 10889	75	Vineyard Road Association	NY	Holds FERC Preliminary Permit
West Pass, 10725	10	Little Horn Energy Wyoming Inc.	WY	Holds FERC Preliminary Permit
West Rutland, 11240	160	Village of Swanton, Vermont	VT	Awaiting FERC Preliminary Permit
West Valley Pumped Storage, 10786	175	Juniper Energy Company	CA	Holds FERC Preliminary Permit
West Valley Pumped Storage, 10798	264	South Fork Irrigation District	CA	Holds FERC Preliminary Permit
Willow Spring, 7824	250	Gentry Resources Corporation	AZ	Awaiting FERC Preliminary Permit

Note: Data used in this table was provided by the Federal Energy Regulatory Commission, and is current through March 6, 1992

tute. "It should be evaluated on the basis of its strategic value, not simply on its generating capacity." Birk and others believe that highlighting the beneficial strategic and operating features of pumped storage will contribute to a greater understanding of its compatibility with DSM and related efforts to encourage conservation and environmental protection.

Efforts to improve public understanding of pumped storage were recently boosted with the formation of the National Hydropower Association's Energy Storage Council (HESC). One of the major purposes of this organization is to communicate the purposes and benefits of pumped storage to decision-makers on energy issues at the national level.

HESC and other pumped-storage advocates seek to combine this type of communication with ongoing efforts to better define and quantify the dynamic operating benefits of the technology. The hoped-for result will be to enhance its attractiveness to utilities, regulators, and the public as a whole, and allow the current promise of pumped storage to reach its full potential. ☐

For more information about this article, contact The Editor, Hydro Review, *410 Archibald St., Kansas City, MO 64111; (816) 931-1311.*

Note:

[1] Cunningham, Carol, "A 'Green' Plan for Pumped-Storage Projects," *Hydro Review*, Volume 10, No. 7, December 1991, pages 42-50.

Acknowledgment:

The author of this article and the editor of *Hydro Review* gratefully acknowledge Antonio Ferreira, PhD, P.E., for his contributions to the portions of this article addressing the historical and technological development of pumped storage. Dr. Ferreira is a consulting hydroelectric engineer in Holyoke, Massachusetts, with extensive experience in pumped-storage planning, design, and operation.

Mr. McDERMOTT. Thank you, Mr. Chairman.

Mr. ANDREWS. Thank you, Mr. McDermott.

I want to thank the panel, it has been excellent testimony. This concludes this panel's testimony.

I would like to ask the second panel to please take your seats at the witness table as quickly as possible and, let us proceed with your testimony.

Mr. ANDREWS. If we could call the committee back to order. Our second panel consists of Richard Terry, representing the American Gas Association, Victor Beghini, representing the American Petroleum Institute; Douglas Woosnam, representing the Petroleum Marketers Association of America; and Eugene Ames, representing the Independent Petroleum Association of America.

I would like to ask that the witnesses start with Mr. Terry and work across the witness table. And if you would please try to hold your remarks to 5 minutes. When the red light comes on, please try to conclude your testimony. Your formal written testimony will be made a part of the record.

Mr. Terry, welcome to the committee.

STATEMENT OF RICHARD E. TERRY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PEOPLES ENERGY CORP., CHICAGO, IL, ON BEHALF OF AMERICAN GAS ASSOCIATION

Mr. TERRY. Thank you, Mr. Chairman, and distinguished members of this committee. I am Richard Terry, chairman and CEO of People's Energy Corp., the parent of People's Gas Light & Coke Co. in Chicago and North Shore Gas Co.

I am pleased to be here today on behalf of the American Gas Association and its approximately 250 member distribution and transmission companies in order to present our views concerning the administration's proposed energy tax.

While AGA commends the President on his efforts to put forth a plan for reducing the deficit and strengthening the economy, we believe the broad-based energy tax is not the best way to get the job done.

For a number of reasons, AGA is opposed to all broad-based energy taxes for purposes of reducing the deficit or raising additional Federal revenue. We believe broad-based energy taxes are regressive, regionally inequitable, difficult to implement, and harmful to the domestic economy, job growth and the global competitiveness of U.S. industry.

We believe it is shortsighted to permit the current need for additional revenue, or demands for deficit reduction to dictate energy policy when a sound energy plan is central to promoting the national goals of reducing dependency on foreign oil, improving exports, developing investment infrastructure, and creating jobs.

We urge Congress to work with the administration in cutting Federal expenditures before any new taxes are enacted. However, if it is determined that additional taxes are necessary to reduce the deficit, we urge you to seriously consider implementing a national consumption tax, rather than a tax exclusively on energy consumption. This strategy would not harm selected industries, such as manufacturing, that are heavily dependent on energy.

If a Btu tax on natural gas is inevitable, all segments of the industry are united in encouraging that it be structured as an excise tax paid by the ultimate consumer or end user and collected by the entity selling that gas to that consumer. The tax could be collected by a utility or other seller in the same manner as the current telephone excise tax. This manner of collection would mitigate many of the practical problems associated with implementing the Btu tax.

There is some concern expressed whether this tax would show on the bill. I suggest that it would show on the bill even if it is at the city gate, just like other taxes are on our bill. Collecting the tax at any other point than the end user, such as city gate, well head or pipeline, would create serious market distortions and significant burdens in the collection and administration of the tax.

Moreover, collecting the tax at the end user level avoids building the tax increase into the cost of energy where local jurisdictions impose a gross receipts tax on utility bills. In Chicago, this increases the impact by 14 percent.

If it is determined that the Btu tax is to be imposed at the city gate, many utilities might be hurt in trying to flow the cost of the tax to the ratepayers. In most jurisdictions, the utility would have to seek a fuel adjustment or go through a rate hearing to flow through the tax. A rate case would not only be time consuming and expensive, but the utility could be forced to absorb the cost of the tax while waiting for a rate approval, which might be denied.

The ability to flow through the tax is critical because, for many companies, including our own, the amount of the tax will equal or exceed our current net income. I have been advised that several State commissioners have indicated their interest in examining the flowthrough. The tax should not be applied in a manner that undermines the financial viability of LDC's or other segments of the industry. We, therefore, urge Congress, if the collection point of the Btu at the city gate is unavoidable, to add provisions in tax legislation that would effectively and immediately enable utilities to completely passthrough the cost of the tax to consumers.

The Btu-based energy tax will be, at a minimum, highly complex and difficult to fashion in a manner that avoids serious administrative, financial, economic, regulatory, and operational burdens. The proposed Btu tax will hurt low-income households who spend a much greater percentage of their income on energy than more affluent households. For the average household, AGA estimates the tax would eventually add $25 to the average annual bill. In Chicago, that is closer to $44.

Let me conclude my comments by coming back to an issue that is of highest concern to our industry, where the tax will be collected. If a Btu tax is your choice, we encourage you to have it paid by the ultimate consumer and collected by the seller for the following reasons:

An excise tax could most easily avoid compounding caused by existence of State gross receipt and sales taxes; and, second, the end user collection point would maximize the possibility of complete flow-through of the tax and minimize the gas company's exposure to regulatory lag.

This concludes my remarks. Thank you.

Mr. ANDREWS. Thank you, Mr. Terry.

[The prepared statement follows:]

STATEMENT OF
RICHARD E. TERRY
CHAIRMAN & CEO
OF
PEOPLES ENERGY CORPORATION
ON BEHALF OF
THE AMERICAN GAS ASSOCIATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ON FEDERAL ENERGY TAXES

March 23, 1993

I. Introduction and Summary

Thank you Mr. Chairman and distinguished members of this Committee. I am Richard Terry, chairman & ceo of Peoples Energy Corporation, the holding company of The Peoples Gas Light & Coke Company and North Shore Gas Company. I am pleased to be here today on behalf of the American Gas Association (A.G.A.) in order to present the views and position of the natural gas industry concerning the Administration's proposed energy taxes.

A.G.A. is a national trade association comprising approximately 250 natural gas distribution and transmission companies located throughout the United States. Collectively, 90 percent of the gas consumers in this country are served by A.G.A.'s members.

The Peoples Gas Light & Coke Company serves customers in Chicago while North Shore Gas supplies users in 54 suburban communities north of the city. Together, these utilities serve nearly a million customers and are primarily engaged in the purchase, storage, distribution, sale and transportation of natural gas.

While A.G.A. commends the President in putting forth a plan for reducing the deficit and strengthening the economy, we believe a broad-based energy tax would not accomplish these objectives. For a number of reasons, A.G.A. is forthrightly and unequivocally opposed to all broad-based energy taxes for the purpose of reducing the deficit or raising additional federal revenue for new programs. We believe broad-based energy taxes are regressive, regionally inequitable, difficult to implement, inflationary, harmful to the domestic economy, job growth and the global competitiveness of U.S. industries.

We urge Congress to work with the Administration in cutting federal expenditures before any new taxes are enacted. However, if it is determined that additional taxes are necessary to reduce the deficit, we urge you to seriously consider implementing a national consumption tax, rather than a tax exclusively on energy consumption. This strategy would not harm selected industries such as manufacturing that are heavily dependent on energy. If, however, the Administration and Congress elect an energy tax, A.G.A. believes that an increase in the federal excise tax on gasoline and/or oil import fee are the most appropriate means for raising revenue efficiently, improving the environment, encouraging domestic production and promoting energy conservation.

If a Btu tax is enacted such as that proposed by the Administration, its point of collection should accurately reflect the current state of the industry. The natural gas industry has endured a decade of radical restructuring towards a market-based system at the production and wholesale levels. It still faces extensive state regulation of retail operations. These two factors make the collection point of the Administration's proposed Btu tax extremely important.

If an energy tax on natural gas is inevitable, A.G.A. is united with all segments of the natural gas industry in encouraging that it be an excise tax paid by the ultimate consumer or end-user and collected by the entity selling the gas to the consumer. Under no circumstances should the collection point be at the city-gate.

If Congress and Administration impose a Btu tax on natural gas, we urge that its collection be at the end-user level to best address a number of problems that could occur if the tax is imposed at some other location, such as the wellhead, pipeline or city-gate.

We are greatly concerned regarding the possibility that gross receipts and state sales taxes could be levied upon the Btu tax, if the collection point issue is not carefully addressed. This compounding, or tax on a tax, will occur if the Btu tax is assessed at the city-gate or anywhere else other than on the buyer in a final sale. When energy taxes and other state taxes are piled on top of each other, it could result in much higher out-of-pocket costs. A.G.A. estimates that the magnitude of the compounding problem could range from $350 to $400 million annually after the tax is phased-in.

Another major problem that concerns us is that of federal/state regulatory preemption -- whether some state public utility commissions (PUCs) will allow the full tax to be passed through in consumer rates. This could create a problem of "stranded costs" -- pipelines and local distribution companies (LDCs or utilities) being unable to pass these costs through to ratepayers. A related concern in those jurisdictions that would allow a flow through of costs is the regulatory lag in the time between the imposition of the tax and reflection of the tax in the customer's billed rates. Where the tax is paid by the local distribution company (LDC or utility) and there is the usual regulatory lag, the gas company's entire net income could be lost for that period.

An additional problem in collecting the tax at a point other than the end-user is that lost revenues could result from tax avoidance as well as the fact that utilities prevented by their state regulators from collecting the tax could deduct it as a business expense.

Another concern is that transportation services could be shut down. If the tax exceeds an LDC's transportation margin and the LDC is prevented from passing the tax on to its large commercial or industrial customers, it may be forced to cease transporting gas to them.

Other concerns we have with an inappropriate collection point include: 1) administrative difficulties in collection of the tax; 2) increased gas storage costs; 3) absorption of costs by pipelines, producers and LDCs whose contracts have fixed prices that prevent tax additions; 4) disputes over whom would bear the costs of uncollectibles; and, 5) the potential to disadvantage natural gas vis-a-vis competitors in the marketplace.

Several state commissioners have indicated that they are interested in examining the flow through of tax costs to consumers. An unnecessary major federal/state jurisdictional battle could occur between the federal government, LDCs and state regulators. Therefore, if it is determined that a Btu tax is imposed at the city-gate, Congress should adopt legislation to allow utilities to immediately recover the full costs of the tax in consumer rates.

II. Administration's Proposal

The Administration's proposal to raise $71.4 billion over five years by imposing an excise tax on fossil fuels (natural gas, coal oil) at a basic rate of 25.7 cents per million Btu (MMBtu), plus a

34.2 cents per MMBtu supplemental tax on oil. The tax would be imposed on hydro-and nuclear-generated electricity and on imported electricity according to the fuel Btu content of fossil fuels burned in conventional power plants to produce equivalent power. The tax would be phased in over three years beginning in July, 1994. The energy tax package includes an extension of an expiring federal excise tax on gasoline.

The collection point for the tax as originally proposed by the Administration would be the pipeline for natural gas, the refinery for oil, the minemouth for coal, the production facility for alcohol fuels, the utility for hydro-and nuclear-generated electricity and the importation point for imported taxable products.

III. Impact of the Tax

For the average household, A.G.A. estimates the tax would eventually add $25 to the average annual bill of a natural gas-heated home, roughly $23 to the electric bill. The average household would also pay an additional $76 annually on gasoline consumption. We estimate that the total average household energy costs for a natural gas heated home would rise by $124 per year.

The national average numbers mask the higher impacts that will hit particular regions, especially the northern states with colder winters. According to the Department of Energy, cold weather regions use as much as 55 percent more energy in homes than warm regions. Consequently, the tax burden would be disproportionately larger and unavoidable to the residents of the colder regions. In Chicago, for example, the tax would add $38 to $44 to a typical gas bill, rather than the $24 national average.

But the residential home energy cost is less than half the total cost to U.S. consumers. Approximately $184 in increased annual costs per household would be hidden in the costs of all goods and services that rely on energy as they are made or delivered. We estimate that the total average household cost would be nearly $310 per year. The cost of the tax on the consumer would rise as the tax rate rises with inflation.

The short-term retail price effects of the Btu tax after phase-in are illustrated in the attached Appendix. That chart shows the percentage increase in prices of the energy sources as a result of the tax. For example, the chart illustrates that the proposed tax raises the price in the residential sector by 4.7 percent for natural gas and 4.1 percent for electricity. The proposed tax would raise the price of gas industrial customers by 11 percent while raising that of industrial electric customers by 6.9 percent and industrial coal customers by 15.3 percent. The market effect is that the tax would have a greater impact on the prices to natural gas industrial customers.

IV. The Problems of Broad-Based Energy Taxes

The Btu-based energy tax that is part of the proposed economic package will be, at a minimum, highly complex and very difficult to fashion in a manner that avoids serious administrative, financial, economic, regulatory and operational burdens.

First, it is short-sighted to permit the current need for additional revenues or demands for deficit reduction to dictate energy policy when a sound energy plan is central to promoting national goals of reducing dependency on foreign oil, improving exports, developing domestic infrastructure and creating jobs. The production, delivery and consumption of energy in our country is essential to meeting these national goals and to stimulating economic growth. The complexities of energy markets require

consistent strategies with respect to energy, environmental and economic policies. The consideration of these issues must not be held hostage to a budget crisis.

The proposed Btu tax is in general regressive. Low-income households spend as much as four times the percentage of their income on energy as more affluent households. Therefore, a broad-based energy tax would have a disproportionate effect upon lower income households.

The tax would be felt by consumers using household essentials, such as heating, cooking and water heating. Unlike a proposed "sin" tax on alcohol and tobacco, energy is a basic necessity. Such tax would hit lower income households hard. Reducing energy consumption can entail large expenditures (i.e., new furnace, replacing windows), which are often not affordable by lower income households. These households might need a tax credit to reduce the burden of a broad-based energy tax, or forego certain essentials.

In addition, some A.G.A. member companies have customers who cannot pay their utility bills at current price levels. Some jurisdictions have enacted programs for low-income customers which allow them to defer payment of their gas bills. Where low-income customers have been unable to pay under these programs, a broad-based energy tax could exacerbate this already bad situation. For example, the uncollectible bills in one state for one member company have exceeded $120 million since 1983.

A Btu tax like that proposed could erode U.S. competitiveness and increase inflation. An energy tax would raise the price of U.S. products in relation to foreign products, resulting in fewer exports and more imports.

By taxing energy used in the production of U.S. products, domestic products would become far less competitive than foreign products in world markets. The U.S. would import more finished goods because these products would be made relatively cheaper since the energy used in the foreign manufacture of the product escapes the tax. Domestic companies could be forced to export jobs to remain competitive. Moreover, a broad-based energy tax could increase the cost of domestic manufacturers and reduce their ability to compete with foreign manufacturers in the domestic and world markets. This is hardly consistent with desirable trade policy.

Basic manufacturing industries would be particularly hard hit since they consume relatively large amounts of energy per unit of production. These industries, concentrated in the Midwest, South and Southwest, will already be faced with higher costs resulting from implementing provisions of the "Clean Air Act Amendments." A double cost of environmental compliance and new taxes could result in significant relocation outside the U.S. Our economy can ill afford the drag imposed by a tax which hits both consumers and export products.

The broad-based energy tax can be inequitable on a regional basis. Generally, energy consumption in colder climates is larger than in warmer climates. Thus, taxes on energy consumption would fall disproportionately on colder regions like the upper Midwest and Northeast. Many of these areas have already been hit hard by the loss of manufacturing jobs.

A Btu tax as that proposed can present various administrative problems. Implementation could create a new layer of bureaucracy at the IRS at a time when the President proposes that federal government staffs be cut. In addition, utilities could face different requirements in passing such taxes on to customers by the various state and federal regulatory commissions.

It may be difficult for federal government auditors to verify the amount of Btus consumed if the tax is collected upstream, since fossil fuels are not uniform in their Btu content. When natural gas is produced, it is either in a wet (containing liquid by-products) or dry state (no liquid by-products). The Btu level of the gas will vary widely depending upon its Btu content. A cubic foot of natural gas produced from the same well may have different Btu contents on different days because deposits of natural gas can vary considerably.

Under the proposed Btu tax formulation, taxpayers would be required to pay the tax on an exact Btu content, requiring extensive laboratory testing by the taxpayer. Serious compliance problems could occur, as Service agents are ill-equipped to detect noncompliance through misreporting of fuel quality.

A flat BTU tax, as that proposed, may favor the use of electricity over natural gas in some applications. For instance, in the generation of electricity, approximately two-thirds of the input fuel BTU value is lost due to inefficiencies in generation and transmission. A BTU tax at the retail level could, therefore, penalize customers who heat directly with gas where efficiency levels approaching 90 percent can be achieved.

The Btu on gas would be imposed on an industry whose prices have been depressed. These low prices have affected the number of new jobs created in the industry and a Btu tax added on gas will not improve the future outlook for jobs. Natural gas prices have fallen between 1984 and 1993 in the wake of deregulation and the imposition of market forces. Since 1984, the average gas wellhead price has declined from $2.66 per thousand cubic feet of gas (Mcf) sold to $1.64/Mcf for 1991.[1] During the same period, the average natural gas prices to residential customers expressed in dollars adjusted for inflation declined from $6.12/Mcf to $5.82/Mcf. Commercial and industrial sector prices have fallen by $.74/Mcf and $1.71/Mcf respectively from 1984 to 1993.[2]

Pipelines and gas utilities lowered the average delivered prices by more than the decline in wellhead prices. While beneficial for the consumer, these falling gas prices at the wellhead and to end-users have made it more difficult for the natural gas production sector to maintain activity levels needed to fully replace production with new reserves of natural gas. These depressed prices have stifled the creation of new jobs in the exploration and production sectors of our industry.

V. <u>Why Ultimate Purchaser is Most Appropriate Collection Point for Natural Gas</u>

A. Criteria and Analysis in Selecting Collection Point

Of major concern to our industry is the point of collection for any Btu tax which might be enacted. If a Btu tax is enacted, we urge Congress to adopt provisions for collecting the tax from the ultimate customer (last sale) via the entity that sells the natural gas. The Administration's original proposal, however, is that the tax be collected on natural gas entering the pipeline. More recently, they have indicated the collection point is to be "out of the pipeline," i.e., the point of delivery to the local utility or the point of delivery to the end-user, where the end-user does not receive deliveries through an LDC.

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[1] U.S. Department of Energy, <u>Monthly Energy Review</u>, Feb. 1993.

[2] <u>Id.</u>

1. Criteria

It is vital that if a Btu tax is adopted that the collection point be logically and reasonably integrated with the industry's structure, business arrangements and other practical considerations. For example, the collection point should be one that is least likely to produce uncertainties about private contract rights. In addition, the collection point issue should be evaluated in light of the following factors: 1) whether the tax is easy to collect and discourages tax avoidance; 2) whether the tax can be flowed through to consumers; 3) whether regulatory approval is required in most cases which could expose gas companies to a regulatory lag problem; and, 4) whether the government can adequately collect revenues.

2. Changes in Gas Industry

First, the natural gas industry is undergoing a significant transition -- the result of decades of legislative, regulatory and market-driven changes. Gas markets have been hampered by problems left over from the era of wellhead price controls and extensive regulation. During the 1970s, the industry saw a combination of wellhead price controls, rising demand and concerns about gas supply. During the decade between 1979 and 1988, the industry grappled with such problems as high take-or-pay requirements in contracts that were unresponsive to the market, a regulatory process ill-suited for an increasingly competitive market and the concern in some quarters regarding future gas supplies and markets.

Since 1984, the natural gas industry has undergone changes from a structure of rigid regulation to a regulatory regime that relies on market forces. During the regulatory change, the wellhead market for the natural gas commodity was deregulated. This was accomplished through a phased approach, whereby regulated price ceilings were largely removed in 1985, although the last vestiges of wellhead price regulation were not removed until January, 1993.

Moreover, structural changes in the transmission and distribution sectors of the natural gas industry have affected the pricing of natural gas services and the industry. While both sectors remain regulated, a series of regulatory actions -- including Federal Energy Regulatory Commission (FERC) orders for open access transportation, changes in facility and service certification, and rules to allow pipelines to sell gas at negotiated rates, while providing gas buyers with greater access to a competitive wellhead market -- have resulted in market forces replacing regulation as the principal factor affecting industry pricing and operations. These regulatory changes have resulted in a significant re-ordering of gas rates (prices).

Of the collection point options, wellhead, pipeline, city-gate and end-user, the latter option best facilitates the regulatory and market changes occurring in the industry. This is because the end-user collection point would disadvantage natural gas' competitive position relative to competing energy sources the least. Collection at the wellhead could depress natural gas prices and discourage domestic exploration and production. If the incidence of the tax is at the city-gate, competition could be thwarted by encouraging sellers to by-pass the LDC and sell directly to the industrial end-user, thus resulting in higher gas prices for native load customers.

Imposing the tax on the pipeline creates difficulties in that pipelines conducting business under the FERC open-access rules are legally precluded from knowledge of the price and, in some instances, the identity of the ultimate purchaser. Additionally, since state gross receipts and sales taxes are collected on the basis of total costs, collection at the pipeline could result in

state taxes being levied on top of the federal tax, making natural gas somewhat less competitive in the marketplace.

3. Collection of Tax

Second, a broad-based energy tax should be evaluated in terms of its ease of collection, simplicity and tax avoidance. A retail-level tax on gas delivered to the ultimate consumer is the most appropriate collection point option which meets these requirements. Such a tax would be collected primarily by LDCs and added to the bill of each customer. Because most gas LDCs have computerized billing systems and are already structured to collect state sales taxes, the tax could be implemented quickly and efficiently. Other sellers to end-users (i.e. marketers, also have sophisticated billing systems capable of collecting a Btu tax). An excise tax on gas would mirror what is currently done with the telephone excise tax.

Choosing the city-gate as the collection point fails to meet this criteria. An "out of the pipeline" scenario would place the tax on gas LDCs at the city-gate for nearly 60 percent of natural gas consumed in the U.S. The remaining 40 percent consists of thousands of relatively small transactions involving primarily custody but not title changes in gas. Thus, LDCs do not take title to or administratively control 40 percent of the gas that goes through their system.

As a result of industry restructuring, there is no longer a clearly definable "city-gate" in the natural gas industry. More importantly, given the number of pipeline to pipeline transfers involved in transporting gas, including small diameter, short distance pipe that delivers gas to many end-users, and the difficulty of defining what the Administration means by the phrase "out of the pipeline," there is the potential for some to avoid paying the tax collected at the city-gate. Further, under FERC Order 636[3], pipelines own little or none of the gas they transport to the LDC system. Thus, the city-gate collection point becomes difficult because neither entity has title to the gas. Indeed, for much of the gas delivered to the LDC, for which the LDC is just a transporter, the pipeline and LDC do not even have contractual privity. There is no basis for the pipeline to bill the LDC for these quantities.

Collection of the tax at the wellhead creates problems as well. Since there are thousands of independent and integrated oil and gas exploration and production companies in the U.S., such a large number of producers invites difficulties with collection and administration of the tax and problems of tax avoidance.

While collecting the tax at the pipeline would reduce the number of collection points for the Administration, that location is complicated by considerations of gas placed in storage. The Administration's proposal will require owners of natural gas storage facilities to pay taxes on their inventories or "floor stocks." For pipelines, and some LDCs, the Btu tax imposed on storage gas would reach some gas which may be lost rather than consumed. Taxing gas in storage creates a mismatching, where the

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[3] The Federal Energy Regulatory Commission issued Order Nos. 636, 636A and 636B that provide for a major restructuring of the way interstate natural gas pipelines work. The impetus behind the major restructuring rule is to allow pipelines for the first time to sell gas at negotiated rates similar to the way non-regulated companies sell gas and ensure that gas buyers have greater access to the competitive wellhead market. The central feature of the restructuring rule is the unbundling of interstate pipeline sales and transportation services. However, pipelines are permitted to offer sales and transportation services in a repackaged format if the rate for each service is separately stated.

tax may be paid far in advance of ultimate sale and subsequent collection.

Another problem with imposing the tax at the point gas is injected into the pipeline is that the tax would be imposed on top of a transportation charge instead of the gas cost. This might not only create administrative and tax avoidance problems, it might also subject the tax to regulatory review.

4. Flow Through and Regulatory Lag

Third, the collection point should maximize the possibility of complete flow through of the tax and not disadvantage gas versus competitors in the marketplace. The tax should also minimize the gas company's exposure to a regulatory lag problem. If history is any guide, regulators will treat the flow through of taxes differently in each jurisdiction. In some jurisdictions, the entire amount of the tax will likely be passed on to customers immediately. Collection of the tax in other jurisdictions might be delayed by a cumbersome regulatory process that could take several months or a year to complete. While this review process is ongoing, the utility might have to absorb the tax until the state PUC acts.

In some jurisdictions, it is questionable whether utilities would be allowed to pass the entire amount of the tax on to their customers. Several states commissioners have indicated they are not willing to allow utilities to pass through the tax in consumer rates and the State of California has scheduled hearings on the issue. An unnecessary major federal/state jurisdictional battle could occur between the U.S. Treasury, LDCs and state PUCs.

Pass through can be approached in either of two ways: 1) applying the tax directly on the ultimate consumer in the form of a natural gas excise tax; or, 2) including the tax in the original cost of the gas commodity.

If the tax is an excise tax collected from the end-user, the LDC would not necessarily need to go through the state public utility commission for purposes of flow through. Further, the competitive position of natural gas could be improved through the choice of the excise tax option since this tax could most easily avoid other problems, such as compounding caused by the existence of state gross receipt or sales taxes. In addition, this formulation might avoid payment of the tax on the theft, loss and unaccounted for gas, and possibly pipeline shrinkage. Together these factors could increase the tax burden on natural gas by as much as 10 percent.

If the tax is imposed at the wellhead, many LDCs might have a good relatively chance of recovering the entire tax in rates since the tax could be seen as an increase in the cost of gas.[4] While collection of the tax at the wellhead might allow for flow-through of the tax in gas costs and reduce the regulatory lag problem, that point does not meet the other criteria discussed, such as tax compounding, as well as the end-use point of collection.

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[4] Gas utility rates usually consist of two components, purchased gas adjustment (PGA) and a base rate. The PGA is the mechanism that enables a utility to recover the cost of the gas itself. The base rate includes expenses, other than the actual cost of the gas, required to deliver the gas to the end-user, and a fair return on the utility's investment. Costs collected through a base rate are generally subject to a formal rate case proceeding and regulatory lag. If the tax is collected at the wellhead, with respect to purchases of gas by LDCs, we are more comfortable that state commissions will allow the collection of the tax in current PGAs. This could decrease the regulatory lag substantially.

City-gate collection creates difficulties due to the different points and allocation of transportation gas flowing through it. For some companies, there would be no mechanism to allow a flow through at the city-gate. In many cases, a rate case would have to be filed. Some jurisdictions might not allow full pass through of the costs of the tax and subject utilities to absorbing those costs. In other jurisdictions, regulatory lag might become a problem, and a persistent one, given that the tax rate will change each year. Such problems could be critical because the amount of the tax will often equal or exceed an LDC's annual net income. For these reasons, collection at the city-gate is totally unacceptable. If the incidence of the tax is at the pipeline, there would be concerns of regulatory review where the tax is imposed on top of the transportation charge rather than the gas cost.

5. Revenue Considerations

Federal revenues could be affected depending on where the tax is assessed. Collecting the tax at the wellhead or pipeline raises questions pertaining to the treatment of gas placed in storage. If the tax is imposed at the city-gate, some utilities are likely to experience a larger volume of uncollectibles. If LDCs are able to collect the Btu tax from their customers because of state regulators, the tax would become an expense for federal income tax purposes and 36 percent of the Btu tax would be lost. Also, a collection point any where upstream of the final sale will almost certainly touch off a flood of litigation over contractual obligations to pay the tax.

B. Additional Concerns

1. City-gate

Collecting the tax at the city-gate builds the tax increase in the cost of energy where the local jurisdiction imposes a gross receipts tax on utility bills. For example, the State of Illinois imposes gross receipts taxes over five percent and the City of Chicago adds a municipal gross receipts tax of eight percent, while the State of Texas imposes a two percent gross receipts tax on residential users of gas and the City of Houston imposes a four percent tax.

2. Pipeline

The tax could be avoided by locating an industrial facility adjacent or close to a production field and avoiding pipeline involvement. Another concern regards accounting for compressor gas and shrinkage. Gas entering the pipeline is greater than the amount actually delivered to the end-user because of gas used in the utility's operation, such as compressor gas, and gas lost in the pipeline.

Further, pipelines, and to a lesser extent LDCs, are by and large transporting gas rather than selling it. Pipelines and utilities may not know the identity of the owner or shipper of the gas, the selling price of the gas or the final destination. Federal regulations prohibit the transporter, primarily the pipeline, from having access to some of this information in order to encourage competition.

3. Wellhead

Imposition of the tax at the wellhead raises several additional concerns. First, collection of the tax would impose an administrative burden on producers, especially the large number of independent producers with fixed price contracts. This administrative burden could be a significant factor in their continued viability. Many low volume stripper wells, which are

marginally economic, would feel the pinch of these additional costs.

Because of the varying Btu content of natural gas, there would be wide disparities in the tax from well to well. A tax imposed further downstream, at the end-user level, after the tax has been separated into its different Btu components, would result in a more efficiently administered tax.

The Administration's proposal would allow for a natural gas feedstock exemption (natural gas used by the buyer for non-fuel purposes) from the Btu tax. Because of restructuring in the natural gas industry, pipeline operators rarely know the end-use of the gas they are transporting. If the tax is collected at the wellhead, it would be difficult to administer the feedstock exemption. The seller to the ultimate buyer is in the best position to know whether the natural gas would have a non-fuel use and thus qualify for this feedstock.

VI. Preemption

If a Btu tax is imposed on our industry and at the city-gate, we urge Congress to enact preemption language that will allow local utilities to flow through the tax costs to customers in their gas bills. Many utilities operate on a small profit margin. If the tax is collected at the city-gate, many utilities would have to seek approval from their state PUCs to pass the costs through to customers. Some jurisdictions may not allow flow through or complete recovery of costs. If the utility has to absorb the 25.7 cents MMBtu tax because of a denial of flow through or while waiting for approval to pass through costs, this could essentially wipe out the utility's profit margin. The tax should not be applied in a manner that undermines the financial viability of LDCs or any other segment of the industry.

We therefore urge Congress, if a Btu tax at the city-gate is unavoidable, to add provisions in the tax legislation that would effectively and immediately enable utilities to completely pass through the costs of the tax to consumers. We would work with you to develop necessary language in a bill.

VII. Conclusion

A.G.A. opposes all broad-based energy taxes because of their impact on the economy, balance of trade, lower income households, competitiveness and the natural gas industry. Before any new taxes are adopted, we encourage Congress to work with the Administration in finding additional spending cuts. A.G.A. urges Congress to consider a national consumption tax as a long-term deficit strategy.

If an energy tax is adopted, A.G.A. believes an increase in the federal excise tax and/or oil import fee would foster environmental, efficiency and domestic security goals. If Congress chooses a Btu tax as proposed by the Administration, A.G.A. opposes collection of the tax at the city-gate. A.G.A. is united with the natural gas industry in urging that any Btu tax enacted be paid by the ultimate consumer and collected by the entity making the sale to that purchaser. Attempting to impose the tax at any point other than the end-user will result in significant burdens in collection, operations, administration and flow through of the costs of the tax in consumer rates. It would also thwart the Administration's stated goal of preventing serious economic distortions.

If a Btu tax is to be collected at the city-gate, strong preemption language is needed to minimize the costs of absorption upon utilities.

Mr. ANDREWS. Mr. Beghini.

STATEMENT OF VICTOR G. BEGHINI, MEMBER, BOARD OF DIRECTORS, AND AMERICAN PETROLEUM INSTITUTE, PRESIDENT, MARATHON OIL CO.

Mr. BEGHINI. Good morning, Mr. Chairman, and members of the committee. My name is Victor Beghini. I am president of Marathon Oil Co., and I am testifying on behalf of the membership of the American Petroleum Institute.

We endorse the President's goals of reducing the deficit, creating jobs and enhancing long-term economic growth, and we applaud his efforts to reduce spending, and we are gratified the Congress chose to make additional cuts in this regard. We do, however, oppose the Btu tax as part of the package.

A recent NBC News/Wall Street Journal poll found 62 percent opposed the tax, with 35 percent favoring it. Clearly, many people are concerned about the effects on jobs and income. The Btu tax will distort energy markets, make U.S. products less competitive in world markets, and retard job growth in the economy.

By taxing production, the tax will most seriously affect the competitiveness of energy-intensive U.S. industries, such as refining, steel, lumber, aluminum, airlines, and agriculture. And that is a small list.

The tax will create highly inequitable results across income groups and across regions of this country. It places the greatest burden on lower-income and middle-income Americans, who spend a greater proportion of their income on energy.

The tax will cripple the domestic refining industry, reduce domestic energy production and narrow the field of competition in the industry by driving some small- to medium-sized firms out of business.

The most onerous aspect of this tax for our industry and its customers is that the rate on petroleum is 2⅓ times greater than the tax on competing fuels. For an industry that has lost 450,000 jobs over the past decade, and is spending billions of dollars annually to comply with new environmental mandates, this additional blow is unconscionable.

The results of a recent DRI-McGraw Hill study show by 1998 the Btu tax will result in a loss of GDP of nearly $34 billion annually, resulting in the loss of 400,000 jobs.

For all of these reasons, Mr. Chairman, the API urges you and this committee to reject the Btu tax. However, if Congress does decide to move forward with this proposal, there are a number of design issues which must be addressed. Let me highlight three major areas of concern.

Point of tax collection is a major issue. As you can see from the energy flowchart, the tax could be levied at any number of locations, each with its own set of complications. Imposing the tax on receipt at the refinery is particularly onerous because it gives a competitive advantage to imports over domestic products. This impairs national security, since it would result in an increase in imports of refined products.

For our business, imposing the tax on refined products further downstream, where they break bulk, or as we say "at the rack," al-

leviates some of the distortion problems and would simplify the administration and collection of the tax.

A second major issue is the taxation of the fuel used to make fuel. Large volumes of energy are consumed in producing and refining petroleum products. At production sites using conventional technology, for example, fuel and related costs account for 25 to 40 percent of oil and gas production cost. Marginal production, enhanced oil recovery and production in hostile environment areas are even more energy intensive. This tax will lead to a greater reliance on foreign crude, further posing a threat to national security.

Petroleum refining, likewise, is an energy-intensive process. And if domestically refined products are forced to carry the embedded cost of the tax on the fuel used to produce them while imported products do not, domestic refiners will be put at a further disadvantage and the country will substitute refined product imports for crude oil imports. In order to avoid this additional tax burden, fuel consumed in extracting and refining taxable fuel should be exempt from the tax.

A third problem is that the tax rate is indexed to inflation. Over the last 10 years, the price of crude has fallen 44 percent while measured inflation has increased by over 44 percent. At a minimum, some provision must be made to limit the effects of increasing taxes during periods when product prices fail to keep up with inflation.

In summary, Mr. Chairman, API supports the President's goals but has strong reservations about the proposed Btu tax. If additional revenues are needed, we suggest that a broad-based consumption tax would be better suited to improving U.S. competitiveness and enhancing long-term growth.

Nevertheless, if the committee moves forward with the Btu tax, we would like to work with you and the administration to make it less onerous and more manageable.

Thank you very much for this opportunity to testify.

Mr. ANDREWS. Thank you.

[The prepared statement follows:]

TESTIMONY OF VICTOR G. BEGHINI
American Petroleum Institute

This statement regarding President Clinton's proposals for public investment and deficit reduction is submitted on behalf of the American Petroleum Institute (API). API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

API POLICY

API has long supported the notion that growing federal deficits sap the vigor of the American economy by crowding out productive private sector investment, and we applaud the President's efforts to take serious steps to reverse this process, especially the spending reductions that are included in the package. Spending growth, not reduced revenues, is the primary cause of the current deficit. Federal spending, at nearly 24% of national income, is the largest drain on the private economy. Since the mid-1960's, federal revenue as a percent of GDP has remained relatively constant at 18-19%. On the other hand, federal spending as a percent of GDP has grown over the same period from 17.6% to 23.5% in 1992.

We also agree that the individual elements of the President's plan should not be assessed in isolation, but rather in terms of their effects on achieving the goal of the overall plan, namely to enhance future prospects for U.S. economic growth. It is on those grounds that we oppose inclusion of the Btu tax in the plan. The Btu tax distorts energy markets; increases the costs of all U.S. goods; makes U.S. products less competitive in world markets; imposes the added burden of administrative complexity; and, creates highly inequitable results across income groups and across regions of this country. Moreover, it works at cross purposes to other key elements of the President's program, and substantially diminishes the prospects that the program will enhance U.S. economic growth prospects.

If, after all appropriate spending reductions have been achieved, additional revenues are required, we believe that a broad-based credit invoice Value Added Tax is the preferable alternative. It has few of the adverse effects of the Btu tax, and would, instead, reinforce the elements of the President's package intended to restore vigorous long term growth to the U.S. economy.

THE BTU TAX

Economic Effects

If passed on fully to consumers, the Btu tax will raise the cost of fuel consumed in the United States by about $31 billion per year by the time it is fully phased in in 1997. Moreover, because of the higher tax on oil, revenues derived from petroleum products will constitute a disproportionate share of the total. While petroleum consumption is expected to account for only about 39% of Btus consumed in 1997, it will account for about 60% of revenues from the tax.

The Btu tax will raise consumer prices of virtually all energy in the United States. But, contrary to Administration goals, the burden of these increases will not be spread fairly across income classes, regions or industries. The tax will be borne overwhelmingly by the middle class, with the burden especially pronounced in the lowest income groups. CBO estimated that the proposed Btu tax would consume 1.1% of the income of families in the lowest income quintile, compared to about 0.3% of income in the highest quintile.

Across regions, there are wide disparities in the patterns of energy consumption. One of the principal factors affecting these regional variations is the wide diversity of energy use patterns

by industry. Petrochemical, aluminum, and many other types of manufacturing inherently require substantial amounts of energy to produce their products, while other industries such as services, require less. The tax thus singles out U.S. manufacturing and certain other sectors (such as transportation, e.g. airlines, rail, etc.) to bear the heaviest burden of the tax.

These discriminatory impacts are particularly a problem for those firms producing goods to compete in world markets. Petrochemicals and aircraft manufacturing are two such industries, but there are many others who will be unable to pass through the tax on the world market. It has been argued by some that U.S. energy costs are so low by world standards that this tax won't affect our competitiveness. This is simply wrong. In particular, if we look at our North American trading partners, Mexico and Canada, industrial energy prices in the U.S. are generally as high or higher already. Fuel oil for industrial use, for instance, is about identical in price between the U.S. and Canada, but currently 37% to 50% higher than Mexico. Natural gas in industrial use is about a third more costly in the U.S. than in Canada or Mexico. The Btu tax will exacerbate these differences, conceding competitive advantage to these trading partners.

API has asked DRI-McGraw Hill, a noted international economic consulting group, to examine the effects of the President's package, both on energy markets and on the U.S. economy. The DRI results show that the Btu tax by 1998 (less than 1 year after its full implementation) will result in a loss of GDP of nearly $34 billion annually in 1993 dollars, resulting in a loss of about 400,000 jobs. This will cause other government revenues tied to economic activity to be lower, and expenditures tied to economic activity (such as unemployment compensation) to be higher, than they would be without the Btu tax. These effects offset over 40% of the direct revenues raised by the tax. As a consequence, while the tax raises over $31 billion annually by 1998, the deficit falls by only $19 billion. These results are similar to those reported by other studies.

Second, the DRI results suggest that the tax seriously increases the inevitable short run costs that will need to be incurred to secure the deficit reduction the President is seeking by 1998, and in the process significantly compromises the President's goal of enhancing the long run growth potential of the U.S. economy.

Over the 1993 to 1998 period covered by the President's program, the DRI analysis shows that serious deficit reduction efforts such as those proposed will actually dampen the level of U.S. economic activity and cost jobs. Such costs are transitional, and may be an unavoidable cost of reorienting the economy from consumption to investment. DRI estimates that the program as a whole will reduce the deficit by $117 billion, at a cost of between 500 thousand and 800 thousand jobs by 1998. The benefits of this deficit reduction lie beyond the horizon of the President's proposal. This does not suggest that the President's program is not worth pursuing, since a $117 billion deficit reduction is a sizeable achievement with significant long term benefits. It does suggest, however, that the short run cost of this achievement is likely to be sizeable, and certainly that it cannot be ignored. Particularly, we cannot afford to neglect available revenue alternatives that could achieve the same deficit reduction at substantially lower cost. Our opposition to the Btu tax stems in part from the fact that other revenue alternatives are available to achieve the same level of deficit reduction at substantially lower short term cost than that associated with the Btu tax. Of the 800 thousand jobs lost by 1998 in the DRI study, nearly 400 thousand, or about half, were directly attributable to the effect of the Btu tax. Moreover, the DRI results show that these short run losses could be substantially reduced by the substitution of a broad based Value

Added Tax of equal yield. As a consequence, the Btu tax unnecessarily raises the short run cost of achieving the President's deficit reduction goals.

Perhaps even more importantly, the Btu tax compromises the effectiveness of any given level of deficit reduction in enhancing U.S. economic growth over the long term. The tax permanently raises U.S. production costs, sacrificing U.S. productivity and making the U.S. less competitive in world markets. By contrast, a VAT taxes only consumption, not production, preserving U.S. competitiveness and providing an incentive to private savings which reinforces rather than offsets the effect of deficit reduction.

The Administration argues that the tax will improve our energy security by reducing our dependence on foreign oil. It will reduce oil consumption, by Administration estimates, by about 350,000 barrels per day by the year 2000. If correct, this will decrease U.S. import dependence in the year 2000 by a trivial amount (from about 56% to about 55% of total consumption). However, the tax is also likely to decrease the supply of domestic crude oil and products by an amount sufficient to offset much, if not all, of the expected consumption decline. Fuel and related costs account for between 25% and 40% of oil and gas production costs even at sites using conventional production technology. Btu tax cost increases could reduce oil and gas production from conventional sources by from 20,000 to 100,000 barrels of oil equivalent per day by the year 2000. Moreover, marginal production and production using enhanced oil recovery (EOR), which accounts for more than 10% of U.S. production, may be more seriously affected. The shutdown of EOR projects in California alone could amount to as much as 130,000 barrels per day.

Finally, even if imports were to fall by the full 350,000 barrels a day claimed by the Administration, the cost of $34 billion in lost GDP is excessive relative to other alternatives for improving energy security. Using the Administration's optimistic predictions of import reductions, the cost of the Btu tax works out to about $260 per barrel. By contrast, oil can be purchased for the SPR at a cost of about $20 per barrel, which contributes in a direct and tangible way to U.S. capabilities to respond to any such future interruption. Taking steps to strengthen domestic petroleum production such as opening federal land and offshore areas would provide a means to increase energy security that would enhance U.S. economic performance, not detract from it. Given these alternatives, it is implausible that any small reductions in oil imports attributable to the Btu tax represent a cost effective way to address U.S. energy security concerns.

Second, the Administration argues that the tax represents a desirable way to reduce emissions from the burning of fossil fuels. Granted, the tax will reduce consumption of energy slightly, but even the Environmental Protection Agency forecasts these effects to be minimal, amounting to about a 0.8% decline in nitrogen oxides and a 0.25% decline in hydrocarbons and carbon monoxide. Moreover, sulfur dioxide emissions, associated with acid rain, could actually increase since the tax encourages a shift from low sulfur western coal to high sulfur eastern coal. In fact, there are far more effective ways to deal with these various emissions than a broad based energy tax. The emissions reductions expected under the Clean Air Act Amendments of 1990 require far more significant, and more targeted reductions. For example, the CAA amendments of 1990 are expected to result in reductions of 15% in hydrocarbon emissions in smog-prone areas, about 17% in nitrogen oxides, and 45% in total sulfur dioxide emissions by the year 2000. By comparison, any environmental benefits associated with the Btu tax are at best small and relatively expensive.

In summary, the Btu tax as currently proposed represents poor tax policy. It offsets rather than reinforces the beneficial effects of deficit reduction. It raises U.S. production costs, making all U.S. products less competitive in world markets. It costs jobs, and reduces GDP by more than the revenues raised by the tax. As a consequence, it seriously damages the effectiveness of the President's program in promoting economic growth.

Market Distortions

The Administration appears to have assumed that the crude oil tax will flow through to refined products based on the products' relative share of some average barrel of crude oil. Hence, their numbers that gasoline will bear 7.5¢/gallon and home heating oil 8.3¢/gallon. That is incorrect. In practice, where fuel substitution is possible, the degree to which the cost of the tax on crude inputs will be passed through to refined products will be limited by the price of alternatives to those products.

In the case of most fuel uses other than transportation fuels, this passthrough will be limited to less than one half the petroleum tax since competing fuels (coal and natural gas) will rise by less than one half that of petroleum. The basic economics of a refinery operation are that lighter products, such as gasoline and propane, tend to be the more valuable in the market place. The heavier products, such as number 2 fuel oil and number 6 fuel oil, contain higher Btu contents but they are not as valuable as gasoline products in the market place. To the extent domestic refiners attempt to recover the additional cost of the tax on gasoline and other transportation fuels, their ability to do so will be limited because imported gasoline will bear only a fixed rate of tax that will be less than the tax domestic gasoline will have to bear. Two things will occur: Gasoline and other light end products imports will increase, and domestic refiner margins will be squeezed even further in order to compete with light end product imports. Both will drive more refining capacity offshore, with consequent U.S. job loss and greater product imports.

This detriment to the U.S. industry will be exacerbated by the difference in transit time between foreign and domestic refined products. Imported product will be taxed one to two days away from its market. If crude for domestically refined product is taxed at the refinery, it bears a tax carrying cost of as much as 20 some days between refinery outlet (tailgate) and market. The added carrying cost for domestic refiners gives imported product an additional advantage.

Point of Collection

Imposing the tax on the tailgate side of the refinery does not resolve all of the distortions, nor does it address the problem related to exemptions discussed below. Imposing the tax further downstream when product breaks bulk at a terminal rack or equivalent is crucial to alleviating many of the market distortion problems.

Imposing the tax at the refinery poses major problems for administering exemptions for petrochemical feedstocks and other non-fuel uses, fuel exports, and the reduced rate for home heating oil. This is because the end use of many petroleum products is not known until very far down the distribution chain.

If the tax is generally imposed at the refinery gate, one of three methods will have to be applied to exemptions: 1) all products would be sold tax-included with the final consumer of the exempt use applying for a refund. This would impose the carrying cost of the tax and cash flow problems on those persons entitled to the exemption and create massive refund claims for the IRS to administer; 2) all dual use products (blendstocks, feedstocks, e.g.) would leave the refinery untaxed with a use tax imposed on the person using them for a taxable purpose; or, 3) a

complex and cumbersome system of exemption certificates would be developed. Either of these latter two methods creates opportunities for tax evasion. Whichever exemption method were chosen, an expensive audit system would be required to ensure proper compliance.

The terminal rack--where most federal gasoline tax is currently collected--is the tax point that creates the least market distortions, provides most easily for administration of exemptions, and offers reduced implementation costs for both taxpayers and the IRS because it can piggyback on an existing collection system.

Energy Content of Manufactured Goods
A major problem with the tax is the increased energy cost embedded in manufactured goods which makes them less competitive with foreign manufactured goods in both domestic and foreign markets. Retaining U.S. industries' competitive position in world markets requires a method of imposing the energy tax on imported products and rebating it on exports. The difficulty of designing and administering such a system is mind boggling. Also, we understand that the General Agreement on Tariff and Trade (GATT) prohibits imports from being taxed at a higher rate than like domestic products.

The problem of increased energy cost embedded in manufactured goods is exacerbated when the energy used by manufacturers of taxable energy is also taxed. For example, in the process of producing and refining oil and natural gas that will ultimately be subject to the BTU tax, the petroleum industry uses large volumes of energy. Taxing energy used to produce oil or natural gas, and other taxable energy, would unfairly impose an additional increase in the embedded energy cost of manufactured products.

Competition with Imported Energy
The Btu tax also makes domestically manufactured energy less competitive with imported energy. Petroleum production and refining is one of the most energy intensive manufacturing processes. If domestically produced petroleum and petroleum products are forced to carry the embedded cost of the BTU tax while imported products do not, domestic refiners will be at a further disadvantage. This would jeopardize further refining capacity in this country and promote the importation of petroleum products--exactly the opposite of the President's stated intention.

Exports - Bunker and Aviation Fuel
If fuel and lubricants supplies to ships do not continue to be treated as exports, the U.S. shipping industry will become disadvantaged vis-a-vis non U.S. shipping companies. With this new tax the cost of fuel and lubricants at U.S. ports will increase by at least $.599 per million Btu or approximately $24.00 per metric ton, approximately a 33% increase for bunker fuel. Fuel and lubricants represent over half the cost of the operation of a ship and this tax will result in an increase in ship operating costs from U.S. ports of approximately 15%. Many U.S. ships (Jones Act vessels) may have little choice but to continue to receive fuel and lubricants from U.S. ports despite the increased costs from the Btu Tax. As a result, they will become significantly disadvantaged to their non-U.S. based competitors who will selectively receive bunker fuel/marine lubricants from foreign ports. This increased cost burden for U.S. shipping comes at a time when the U.S. shipping industry is struggling for survival. Similar issues arise with regard to fuel for planes in international flights.

Hidden Tax Increase - GDP Deflator
The Administration proposes to index the Btu tax to the Implicit Price Deflator, a measure which bears no relationship whatsoever to the value of the energy commodity.

Indexing the tax will lead to a substantial erosion of real income in the oil and gas industry. Over the last ten years, the price of crude oil has fallen over 44 percent while the general price level, as measured by the Implicit Price Deflator, has increased by over 44 percent. If the Btu tax on crude oil were in effect at the beginning of the period, tax collection from the industry would have increased by $9.7 billion at a time when industry profits were depressed and 450,000 jobs were lost. Even natural gas, if taxed at $0.26 per million Btus in 1987, would be paying a $0.375 per million Btu tax in 1992. And this tax would apply to a price that was 25 percent lower over the period. In other words, the Btu tax would have amounted to a tax increase of $2 billion in the face of an $11.2 billion decline in revenue.

The Btu tax will lead to a substantial erosion of real income and cause the loss of thousands of additional jobs in the oil and gas industry unless some provision is made to limit the effects of increasing taxes during periods when product prices fail to keep up with inflation.

NATURAL GAS ISSUES

The API's position is that the energy tax should be imposed on the natural gas consumer at the burner tip and collected by the last seller to that consumer. This ensures a number of administrative efficiencies that benefit taxpayers and the government, does the best job of retaining fair competition between U.S. and foreign natural gas producers and best supports other important government policies, especially the policy favoring the use of clean-burning natural gas.

Administrative Burdens

A burner tip tax minimizes government administrative costs by: restricting the scope of audits to the relatively small group of gas marketers as opposed to the much larger number of producers or consumers; and reducing complexity by minimizing the need for exemption certificates or rebates. The burner tip tax minimizes taxpayer burdens because a commercial billing practice is already established at that point and gas metering is most precise at the delivery point to the consumer.

The burner tip tax avoids the complexity of an upstream or wellhead tax, e.g., non-fuel use exemption issues and the threat of double taxation; unintended additional burdens on producers such as higher severance tax, gross receipts tax and royalty burdens, and fixed price contract sales; timing issues that arise when gas is stored or when there are gas imbalances between pipeline and shippers for long periods of time; and the fact that gas volumes used as line pack will not be used as fuel, at least until gas service is completely discontinued.

Importation of Natural Gas

A burner tip tax eliminates market distortions which otherwise arise in a way that favors imported natural gas. For example, natural gas consumed during processing or transportation might be included in the tax base if imposed at the wellhead on U.S. producers but would not be in the foreign producer's tax base. Any effort to correct this distortion, e.g., by imposing a higher tax rate on imported natural gas, raises GATT issues. If the distortions are not corrected, the result is likely to be reduced sales of domestic natural gas leading to the loss of U.S. jobs and higher imports - results that clearly conflict with other important government objectives.

Other Government Policies

In an effort to benefit consumers and promote the use of clean-burning natural gas, the government has sought to improve efficiencies in the natural gas industry and ensure that long term supplies of natural gas are available at stable prices. A wellhead Btu tax will cause premature shut-in of marginal US gas supplies and discourage exploration for new gas reserves.

Imposing the tax on pipelines or LDCs will result in costly rate and tariff hearings at a time when this industry segment should be concentrating on implementation of the sweeping changes mandated by FERC Order 636. Imposing the tax either at the wellhead or on pipelines will likely inhibit the development of market centers and thereby conflict with government objectives to encourage such development. Consumer demands for more and better services are being satisfied by gas aggregation, increased use of gas storage and exchanges, and open transportation. All these techniques for satisfying growing consumer demands will be impeded if the tax is imposed at any point except the burner tip.

Natural Gas Liquids (NGLs)
NGLs are generally extracted from a "wet" natural gas stream during processing either in the field or at a natural gas plant. NGLs are primarily sold (1) to refiners either as part of a crude oil stream or separately for blending in other refined products (2) to petrochemical companies for use as feedstocks or (3) to distributors for resale to retailers or consumers. The producer or gas plant operator cannot always determine which purchases are exempt non-fuel uses of NGLs and which are not.

NGLs for use in refined products should be exempt from the tax. If the tax on refined products is imposed at the terminal rack or equivalent in accordance with API's position, the BTU content of these NGLs would neither escape taxation nor be double taxed. NGLs purchased as feedstocks by petrochemical companies would be exempt from tax.

The NGLs sold for use as fuel by consumers should be taxed at the gas tax rate at the point of purchase by the consumer and collected by the last seller. For reasons stated above with respect to natural gas, this is the only point of imposition for the tax on NGLs that avoids serious administrative complexities, unintended additional tax burdens on producers, double taxation, unfair foreign competitor advantages and conflicts with government policies favoring efficient, stable natural gas supplies.

CREDIT-INVOICE VALUE ADDED TAX

The API's position is that, since the budget deficit is driven by expenditure growth, Congress and the President should focus on spending reductions. Taxes should not be increased first. If, after all spending reductions are implemented, Congress eventually concludes that there should be significant additional taxes, any new taxes should: 1) avoid penalizing U.S. manufacturing in domestic and foreign markets; 2) be neutral with respect to economic decision-making by businesses and consumers; 3) not be overly regressive or progressive; and 4) avoid negative impacts on incentives to save and invest. The API believes that only a credit-invoice style value added tax (VAT) satisfies these criteria, would have the least harmful effect on the economy, and would be the fairest and most equitable way to raise revenues.

Under a credit method VAT, each firm's tax liability would equal the tax on its sales minus the tax that the firm paid on its purchases of capital goods as well as raw materials. Thus, a VAT does not discriminate against capital as does an income tax. A VAT avoids the numerous distortions that an income tax produces in decision-making throughout the economy: in choices of methods of finance; in choices of form of doing business; in choices of production and technology; and in choices among consumption goods.

Furthermore, it is widely agreed that capital investment in the U.S. should be increased. Thus, it is preferable that any new tax should fall on consumption rather than discourage savings and investment. A VAT meets this objective.

A VAT does not harm U.S. competitiveness in world markets. U.S. manufactured goods are not burdened with a VAT when they are exported, and imports must bear the same tax as comparable domestic goods for sale in this country. A VAT does not interfere with the consumer's decisions about what goods or services to consume since relative prices are not changed. And, a VAT does not have the regional distortions that many energy taxes (such as a Btu tax or a gasoline tax) have and does not fall on but one industry or product.

The credit-invoice VAT--under which the tax is separately stated on each invoice and each business gets a credit for the tax that it paid on its purchases--encourages compliance, effectively accommodates exemptions and a multi-rate tax, facilitates border tax adjustments, does not become a cost of doing business, potentially captures taxes from activities that currently avoid the income tax and places the incidence of the tax on the non-business consumer. Thus, the credit mechanism is superior to other methods of calculating the VAT.

The major arguments against a VAT are that it is regressive, would tempt Congress to expand federal spending, and would be costly and burdensome to implement. The regressivity of a VAT can be offset by changes in either the income tax (e.g., the earned income tax credit) or government transfer programs. Historical data show that VATs do not add to government spending or to total tax burdens that would occur anyway. A study published in the National Tax Journal found that the VAT did not increase the share of GDP going to taxes among countries belonging to the OECD. Growth rates in tax burdens did not significantly differ between non-VAT and VAT countries. While there will be start-up costs with a VAT--as with any new tax--the European experience has shown it to be a more efficient revenue collector than income taxes.

OTHER ISSUES

Corporate Rate Increase and Investment Tax Credit

The Administration's revenue proposals include a 2% increase in corporate tax rates for corporations with taxable income exceeding $10,000,000. The rationale for this increase is that corporate tax rates are low in comparison to historical averages.

Despite the fluctuations in marginal rates during the 1980's, the average effective federal, state and local tax rate on corporate income in 1992 was 30.3 percent, about the same as it was in 1980. Since 1980, federal corporate income taxes as a share of federal receipts have declined 26.5%. However, as a percentage of national income, corporate profits before taxes declined 29% during the same period. Consequently, the reduction in the share of federal receipts generated by corporate income taxes is less than would be expected even if rates had remained constant during this period of declining corporate profits. This highlights the fundamental flaw in the Administration's rationale for raising corporate tax rates, it focuses on marginal rates. The current corporate tax burden is not low by historic standards. Rather, the reduction in marginal rates made during the 1980's was offset by the significant broadening of the corporate tax base.

The Administration's rationale fails to take into account increased tax and other burdens on corporations such as payroll taxes, the loss in 1986 of many significant federal tax benefits, e.g., the investment tax credit and accelerated depreciation, and state and local taxes too numerous to mention. Moreover, corporations are incurring higher administrative costs in efforts to comply with increasingly complex federal and state regulations in the areas of tax, environment, health and safety. For the petroleum industry, particularly, a corporate rate increase would come on top of the added burden of the Btu tax.

For these reasons API opposes increasing federal income tax burdens on corporations at a time when many are reducing payroll and other costs in an effort to remain profitable. While the Administration has proposed a temporary incremental investment tax credit, there are substantial restrictions limiting its usefulness to the corporations that pay the vast majority of corporate income taxes. The limited benefits of the credit will not typically outweigh the investment disincentive resulting from higher federal income tax rates.

R & E Credit Extension
The Administration proposes making permanent the R&E credit retroactively from its expiration on June 30, 1992. The proposal also adds a new rule for determining the fixed base percentage of start-up companies.

The API agrees with the Administration that increasing investment in research activities is important to foster economic growth and technological development, as well as improving international competitiveness, and fully supports making the R&E credit permanent.

AMT Proposal
Included among President Clinton's proposals for stimulating investment is a proposal that would significantly improve the corporate alternative minimum tax (AMT), which has had a negative impact on many industries including the oil and gas industry.

The proposal would revise the AMT depreciation system for property placed in service after December 31, 1993, by eliminating the accumulated earnings (ACE) depreciation adjustment and revising the AMT depreciation preference. Thus, there would be one AMT depreciation calculation at which the annual AMT depreciation would be determined using the 120 percent declining balance method over regular tax depreciation lives. The use of regular tax depreciation lives will be beneficial to API's members as it will accelerate cost recovery for the industry's AMT taxpayers.

As there would be only one depreciation calculation for AMT purposes, the Administration's proposal would also simplify the calculation and the recordkeeping associated with the AMT.

The President's proposal could be improved by changing the effective date to January 1, 1993, thereby encouraging AMT taxpayers to invest now rather than waiting until 1994. It could also be improved by providing a faster write-off than the proposed 120 percent declining balance method.

Increase in Inland Waterway Tax
The Administration's proposal would also increase the Inland Waterway tax from 19 cents to $1.19 per gallon. (This is in addition to a Btu tax of at least 8¢/gallon.) This proposed tax increase conflicts with environmental objectives by shifting from the most fuel efficient transport mode to less efficient transporters. Barge transportation uses 270 Btus per ton mile; rail uses 687 Btus per ton mile; and trucks use 2,343 Btus per ton mile. It also conflicts with the goal of stimulating economic growth by eliminating the ability of some businesses to compete in markets served by water transportation. The use of water transportation provides the only economical means that some businesses have of delivering their products to market. The proposed increase in the fuel cost will eliminate the ability to transport products economically and result in the closure of the businesses in those markets. Costs from new or increased taxes combined with recently enacted regulatory requirements will severely erode the ability of the maritime industry to ensure the long term viability of this lowest cost mode of transportation.

TAXATION OF FOREIGN SOURCE INCOME

The President's proposals in the foreign area include a proposal to treat as passive income interest income earned on temporary investments of working capital in connection with foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI). It is observed that this treatment is different in certain respects from that of other industries. The Administration concludes, at p. 53, that "...there is no sound policy reason for this difference in treatment and that foreign oil and gas ... activities should be put on an equal footing with other industries." In addition to the FOGEI/FORI working capital proposal, changes are also proposed in the treatment of foreign source intangible property royalties and the taxation of certain current and accumulated earnings of controlled foreign corporations.

Working capital requirements and the income they generate are integral parts of doing business anywhere, including outside the Unites States. There is no "incentive" involved in holding working capital. It is required to do business. It is held as part and parcel of the business with which it is associated, and it is inappropriate to attempt to divorce it from that business activity where it happens to be conducted abroad.

The concepts of FOGEI and FORI grew out of Congressional efforts to segregate taxes on FOGEI from other taxes and to treat FORI differently from other types of income. See House Ways & Means Report on H.R. 17488 [Energy Tax and Individual Relief Act of 1974], H.R. Rep. No. 93-1502, 93d Cong. 2d Sess., 58-70. In the context of the myriad of limitations imposed upon taxpayers earning these types of income, it is neither surprising nor remarkable that interest on working capital would be included within the ambit of these concepts. They were broadly drawn in order to adequately segregate FOGEI and FORI from other types of income. Given the other burdens FOGEI/FORI concepts must shoulder, it is appropriate to continue current law treatment of FOGEI/FORI working capital income.

Alternatively, if the policy to put foreign oil and gas activities on an equal footing with other industries is an appropriate one, then a number of other adjustments to the treatment of FOGEI and FORI follow. There is no sound basis itself of the continuation of section 907. The objective of limiting the taxes paid to foreign governments has been supplanted by regulations promulgated in the 1980;s. See Treas. Reg. §§1.901-2 & 1.903-1. There is no sound basis for treating manufacturing operations from refining and marketing differently than other manufacturing operations (see sections 907(b) and 954(a)(5)). In short, the API shares the Administration view that there is no sound policy view for the difference in treatment of foreign oil and gas activities and that our industry should be put on an equal footing with other industries. Repeal of section 907 would be a good start.

With respect to the proposal to treat active foreign source intangible royalty income as passive income, API sees no coherent rationale for reversing the policy judgments made in 1986 and treating foreign intangible royalty income earned from active business operations or from a CFC as passive income. The proposal would place U.S. based taxpayers at a disadvantage relative to their foreign competitors. It would inappropriately differentiate repatriations via royalties relative to dividends and interest. In any event, payments made by one affiliated group member to another should continue to be effectively offset in consolidation.

Finally, the proposal to tax a portion of current and accumulated earnings and profits of CFC's having a specified ratio of passive to active assets unfairly subjects pre-enactment earnings to subpart F taxation. At a minimum, this retroactive feature should be avoided.

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THE ADMINISTRATION'S BTU TAX

Tax Design

The Administration's Btu tax as currently proposed would cripple the domestic refining industry, reduce domestic energy production, narrow the field of competition in the industry by driving some small-to-medium size firms out of business, retard if not negate job growth in the economy, and disadvantage U.S. goods in foreign and domestic markets.

Specifically, the Btu tax is imposed on domestic and imported crude oil received at a refinery, and imported product at the point of importation. Domestic and imported crude will be taxed at a rate based on average Btu content of crude. Imported products will be taxed at rates "equal to the average tax imposed on equivalent domestic products."

Imposition of the tax on natural gas has been described as "at the pipeline," but precisely what that means is unclear. It has also been described by Administration spokesmen as "at the wellhead or first sale."

Exemptions or downstream credits would be provided for petrochemicals and other non-fuel uses as well as exported fossil fuel products. In the case of home heating oil, there will be "an appropriate delay in the phase-in" of the supplemental petroleum tax.

This paper sets out some of the design problems. API believes it would be extremely difficult, if not impossible, to design a Btu tax that would not create inequities in the domestic energy market, disadvantage U.S. products vis-a-vis international competition, and/or be easily administered.

Tax Absorption v. Pass-through

As proposed, the Btu tax would be collected on all fuels as far upstream as possible. In this context, a Btu tax must be considered as a tax on production, not on consumption. The market for petroleum products is segmented and very competitive. There are different considerations for success and failure at each level of the market.

The Administration appears to have assumed that the crude oil tax will flow through to refined products based on the

products' relative share of some average barrel of crude oil. Hence, their estimates that gasoline will bear 7.5¢/gallon and home heating oil 8.3¢/gallon. That is not what will happen in practice. In practice, where fuel substitution is possible, the degree to which the cost of the tax on crude inputs will be passed through to refined products will be limited by the increase in the price of alternatives to those products.

As can be seen from the energy flow chart at Appendix A, the tax could be levied at any of a number of locations, each with its own set of complications. Collecting a Btu-type tax at the wellhead or pipeline entry places the burden of the tax on the producer. Low world oil and gas prices already make it difficult economically for the domestic producer to develop and produce crude oil or natural gas. At this stage of the market, a producer can only pass along increased costs if a refiner is willing to pay. As long as prices are relatively low and imports are available, there is no reason for refiners to pay more than necessary to obtain raw inputs for production. Domestic producers will bear the brunt of any tax imposed at this level.

Imposing a tax at the refinery creates a more complex set of distortions and undesirable effects which will lead to a shake-out in the already struggling domestic refining business. This will mean greater concentration in the industry, fewer American jobs in the "high-end" of the international energy business, and overall diminished refining capacity (a serious national security consideration). The U.S. refining industry today is the most sophisticated and competitive in the world from both a technological and environmental basis, and, as such, adds value to domestic wellhead prices. An important question is whether this will still be true four years from now after the full impact of the Btu tax is felt. The Clean Air Act amendments of 1990 have already required this industry to spend upwards of $30 billion on environmental capital projects just to meet environmental goals. On top of these mandated expenditures, the industry is now being asked to absorb another enormous tax in the name of deficit reduction. Imposing the tax at the refinery creates an incentive for refined products to be imported. The Btu content of crude oil is 5.8 million Btus per barrel. The Btu content of gasoline is 5.3 million Btus per barrel. Since the tax is levied on Btu content, it would be more advantageous to import gasoline, pay a lower tax, and be able to recoup most of that tax at the pump, rather than pay tax on the entire barrel (which contains 20-30 percent of low-value, high-Btu product on which the tax simply will not be recovered in a competitive market).

In the case of most fuel uses other than transportation fuels, passthrough will be limited to less than half the petroleum tax, since competing fuels (coal and natural gas) will rise by less than half that of petroleum. For example, in the case of residual fuel oil, which is a high Btu content fuel, this

means that an additional $2.15 per barrel tax will be remitted to the government but may not be recovered by the refiner. Domestic refiners will attempt to recover the additional cost of the tax on gasoline and other transportation fuels such as diesel and jet fuel. But, their ability to do that will be limited because imported gasoline will bear a fixed rate of tax. For example, assume that the rate on imported gasoline is 7.5¢ per gallon. But a domestic refiner, in order to recover the tax on the crude he processes must increase his price for gasoline by 10¢ per gallon. If the market will not bear the added cost of the tax due to competition with imports, refineries and/or producers will bear the added cost. Thus, some refineries will go out of business and imports of refined products will increase to offset the decline in U.S. refining capacity.

This detriment to the U.S. industry will be exacerbated by the difference in transit time. Imported product will be taxed one to two days away from its market. If crude for domestically refined product is taxed on the inlet side of the refinery, it adds another four days to what is already as much as 20-plus days between refinery outlet (tailgate) and market. The carrying cost of the tax for domestic refiners would give imported product an additional advantage.

To minimize the impact on domestic producers and refiners, taxes should be collected as far downstream as possible. The terminal rack--where most federal gasoline tax is currently collected--is the tax point that creates the least petroleum market distortions, provides most easily for administration of exemptions, and offers reduced implementation costs for both taxpayers and the IRS because it can piggyback on an existing collection system. Collecting tax at the rack would still allow enforcement authorities to monitor tax compliance without creating financial hardship for small and mid-size companies. However, even with these suggestions to ameliorate the tax passthrough risk, the refiner is not assured of full passthrough. Any deficiencies in passthrough will ultimately move back to the producer through reduced crude prices. This will impose additional hardships on domestic energy production and escalate the abandonment of marginal wells.

Fuel Used to Produce Fuel

In the process of producing and refining the fuels that will be subject to the Btu tax, the petroleum industry uses large volumes of energy. Taxing this "fuel to make taxable fuel" would unfairly impose an additional increase in the price of domestically produced petroleum products.

Imposing the tax on fuel used in production means many stripper wells will become uneconomical, royalty payments to landowners and government will decline, and there will be less incentive for the domestic producer. The added cost could

imperil as much as one (1) million out of a total of seven (7) million barrels per day of U.S. crude oil production. This will lead to even greater reliance on foreign crude.

Enhanced oil recovery (EOR) projects also consume large quantities of fuel. Enhanced oil recovery projects are designed to produce either oil that is not recovered by primary depletion methods or that is too heavy for conventional production methods. Waterflood/CO_2 injection projects increase oil recovery an additional 15-20% while steam injection recovers about 10-15% of the heavy oil that otherwise would not have been produced. These processes, particularly heavy oil, require fuel gas to either generate electricity, compress CO_2 or generate steam for injection. Fuel requirements for these processes significantly exceed primary production fuel/energy requirements. Taxing these energy requirements will penalize efficient recovery of domestic petroleum reserves.

EOR accounts for 10% of domestic production. When domestic production becomes uneconomical, production will be replaced by imports, further undermining independents' as well as majors' efforts to preserve exploration and production jobs in the U.S.

The tax burden on the energy sector would be lessened if energy producers were allowed an exemption or rebate for the tax on energy consumed to produce taxable fuels. This would include the tax on electricity purchased by refineries as well as the tax on any other purchased fuel consumed in the refining process such as natural gas or NGLs.

Fossil Fuel Exports

The U.S. exports over 1 million barrels per day of petroleum products during some winter months. These exports add significant value to imported crude and help improve our trade imbalance. The Btu tax can put all of these exports at risk if they are not shielded from the indirect effects of the tax.

Exemptions

The Administration's proposal would grant a Btu tax exemption for non-fuel and feedstock uses and exports of fossil fuels. It would also exempt home heating oil from the $2.00 per barrel oil surcharge for some undetermined period. Undoubtedly, other exemptions will be devised and added to the tax as it moves through the legislative process. As the tax base is whittled away, however, the question arises whether the total revenue "take" from the tax will remain at $90 billion over the next 5 years. If so, the rate of tax will necessarily have to be raised, the burden shouldered by the remaining taxpayers will be even greater, and the market will incur additional and exacerbated distortions.

Imposing the tax at the refinery poses major problems for administration of the exemptions. Refinery product slates vary constantly, depending on type and quality of crude, seasonal demand, etc. How will the amount of the exemptions be determined? Who is entitled to the exemption or credit? Furthermore, how will the exemptions be administered? The end use of many petroleum products is not known until very far down the distribution chain.

If the tax is imposed at a point where the end use of the product cannot be known, one of three methods will have to be applied: 1) all products would be sold tax-included with the final consumer of the exempt use applying for a refund (this would impose the carrying cost of the tax and cash flow problems on those persons entitled to the exemption and create massive refund claims for the IRS to administer) 2) all dual use products would leave the refinery untaxed with tax imposed further downstream on the person using them for a taxable use; or, 3) a complex and cumbersome system of exemption certificates would be developed. Either of these latter two methods creates the opportunity for massive tax evasion. Whichever exemption method were chosen, an expensive audit system would be required to ensure proper compliance.

The terminal rack--where most federal gasoline tax is currently collected--is the tax point which creates the least market distortions, provides most easily for administration of exemptions, and offers reduced implementation costs for both taxpayers and the IRS because it can piggyback on an existing collection system.

Competitiveness of Energy-Intensive Manufactured Goods

A major problem with a tax such as this is the increased energy cost embedded in manufactured goods, which makes them less competitive with foreign manufactured goods in both domestic and foreign markets. In 1990, API did an analysis of energy intensive industries using the Commerce Department's input-output tables.

We identified a total of 130 industries whose energy coefficient was at least 5% of the value of their output. For 112 industries, the energy input cost accounted for 16 percent or more of the total outlay. The majority of the firms allocated between 10 to 20 percent of their total cost to energy used directly and indirectly in their production process.

Unless the Btu tax is made border-adjustable to tax the full Btu component embedded in all goods imported into the United States, and rebated on all goods exported from the U.S., our ability to compete in price on high value-added, manufactured goods will be undermined. This will be true for both domestic and international markets.

This is a critical point in supporting taxation of any type. Such taxation policies should not by design disadvantage any American manufacturer's competition with other countries. In fact, such policies should impart an advantage in this regard.

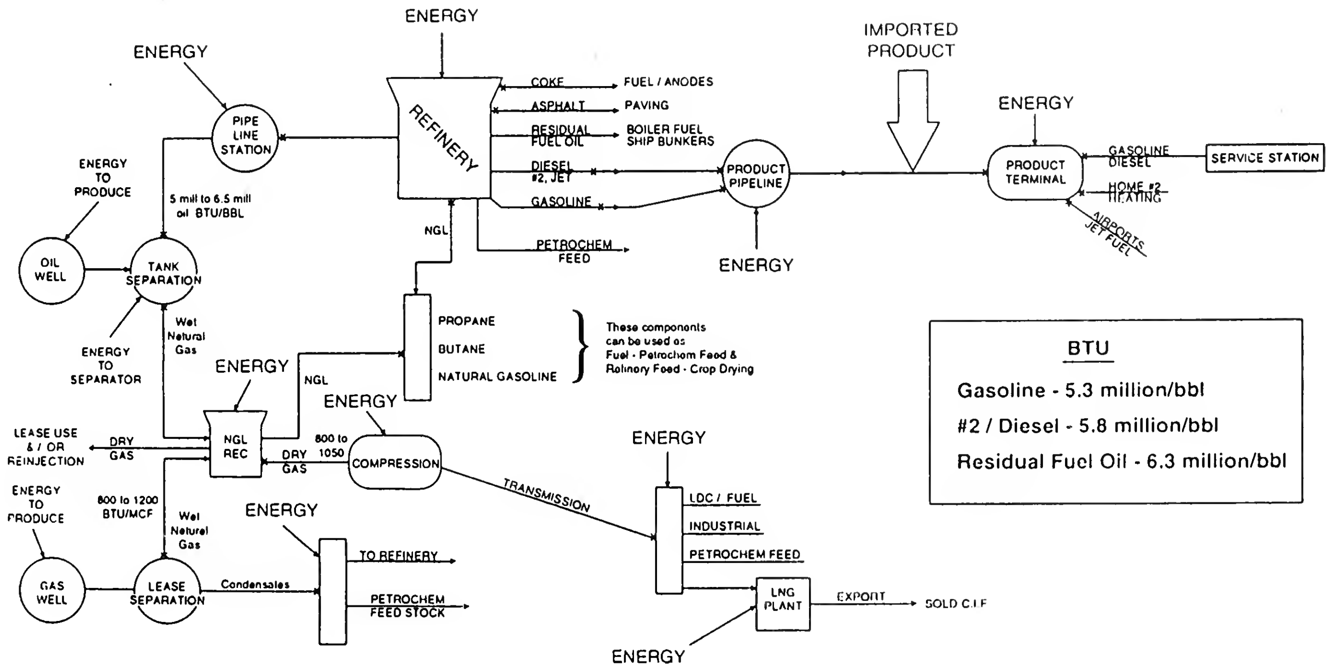
The Indexation Problem

The administration proposes to index the Btu tax to the Implicit Price Deflator. Since this index measure bears no relationship whatsoever to the value of the energy commodity, this tax will be an insidious source of future federal revenue that conceivably will be an even greater threat to the industry's future viability.

Indexing the tax will lead to a substantial erosion of real income in the oil and gas industry. Over the last ten years, the price of crude oil has fallen over 44 percent while inflation, as measured by the Implicit Price Deflator, has increased by over 44 percent. If the Btu tax on crude oil were in effect at the beginning of the period, tax collection from the industry would have increased by $9.7 billion at a time when industry profits were depressed and 450,000 jobs were lost. Even natural gas, if taxed at $0.26 per million Btus in 1987, would be paying a $0.375 per million Btu tax in 1992. And this tax would apply to a price that was 25 percent lower over the period. In other words, the Btu tax would have amounted to a tax increase of $2 billion in the face of an $11.2 billion decline in revenue.

In summary, this measure will lead to a substantial erosion of real income and cause the loss of thousands of additional jobs in the oil and gas industry unless some provision is made to limit the effects of increasing taxes during periods when product prices fail to keep up with inflation.

ENERGY FLOW CHART



Mr. ANDREWS. Mr. Woosnam.

STATEMENT OF DOUGLAS WOOSNAM, CHAIRMAN, HEATING FUELS COMMITTEE, PETROLEUM MARKETERS ASSOCIATION OF AMERICA, AND PRESIDENT AND CHAIRMAN OF THE BOARD, SINKLER, INC., SOUTH HAMPTON, PA

Mr. WOOSNAM. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, on behalf of the Petroleum Marketers Association of America, I welcome the opportunity to testify on the energy tax included in the President's economic proposal. I am Douglas Woosnam, president of Sinkler Inc., a small business located outside Philadelphia engaged in the distribution of petroleum products. I am here today in my capacity as chairman of the PMAA Heating Fuels Committee.

PMAA has traditionally opposed energy taxes as a means of deficit reduction. However, faced with the mounting Federal budget deficit, PMAA is willing to consider supporting a broad-based energy tax applicable in the same manner to all fuels provided that it is coupled with significant cuts in Federal spending. Unfortunately, the economic recovery package submitted by President Clinton and specifically the proposed new energy tax failed to meet those criteria.

I would like to make three main points about this energy tax in my limited time this morning. First, the President proposes the tax on oil be at more than twice the rate as on other fuels. While this supplemental tax unfairly impacts a number of petroleum users, including farmers and truckers, the greatest injustice is that it gives an unfair advantage to natural gas and electricity in the highly competitive residential heating market.

Consider the situation of two identical households in the same neighborhood. Why should the homeowner who heats with oil pay more than twice the level of taxes as his neighbor who heats with a different fuel? As we discuss in our prepared testimony, such a discriminatory policy of taxation does not serve our country's economic, environmental or energy security interests.

Sound energy, environmental tax policy should be encouraging conservation of all fuels, not just oil. This is consistent with recommendations of groups like the Consumer Energy Council of America and Greenpeace.

Greenpeace even states that the cheapest, most sensible way to avoid air pollution and global warming gas emissions from fossil fuels is simply to use less of them. A differential tax does not encourage conservation, it encourages fuel switching. Converting from one fuel to another in the residential or small commercial sector does not benefit the environment or the country.

Therefore, PMAA strongly recommends that the energy tax in its final form be fuel neutral. If this committee does believe a differential tax is appropriate, we strongly urge that home heating oil and off-road users, such as farmers, should be exempt from the supplemental OMB tax. We do not believe there are any sound economic or environmental reasons for an additional tax levy on oil heat customers or farmers.

My second point relates to the indexing of the tax. Indexing will actually serve to increase the oil tax differential over time. For ex-

ample, had this tax been imposed 5 years ago, and the GDP deflator been used in an indexing mechanism, a differential tax on oil would have grown from 34.2 cents per million per Btu to 41.2, a 7 cent increase. This worsens many of the inequities I referred to earlier. PMAA urges indexing be eliminated but, at a minimum, no indexing should be applied for petroleum.

A final concern relates to how the tax is collected. PMAA has been pleased to note that the Treasury Department has indicated in its testimony to the various congressional committees that the Btu tax be imposed on petroleum products leaving the refinery rather than on crude oil entering the refinery. This is clearly a superior approach for a number of reasons, including trade policy and overall industry competitiveness.

We remain concerned, however, over the specific details of the collection process, particularly since our industry has been and remains concerned with the enforcement of existing excise tax collection laws. The supplemental tax gives enough of a competitive advantage to other fuels that legitimate marketers should not be faced with the prospect of competing with individuals who have somehow avoided the payment of the supplemental tax.

We would encourage the committee to consider how existing excise tax collection laws may be tightened, then used to collect a new energy tax that might be imposed rather than developing a new tax system for these products.

I thank you for providing PMAA the opportunity to testify on this important tax proposal and would gladly respond to any questions you may have. Thank you.

Mr. ANDREWS. Thank you.

[The prepared statement follows:]

TESTIMONY OF DOUGLAS WOOSNAM
Petroleum Marketers Association of America

Mr. Chairman, on behalf of the Petroleum Marketers Association of America (PMAA), I welcome the opportunity to testify on the proposed energy tax included in the President's economic proposal. PMAA represents more than 10,000 small, independent, family owned petroleum marketing companies. I am Douglas Woosnam, and I am President and Chairman of Sinkler, Inc., a small business located outside Philadelphia engaged in the distribution of petroleum products. I am serving this year as the chairman of the PMAA Heating Fuels Committee.

My primary business is the distribution of heating oil to residential customers, however, I also distribute heating oil to other retailers, and to many manufacturing businesses. I also sell diesel fuel to trucking and construction companies as well as to farmers.

PMAA has historically believed that the best way to reduce the federal deficit is to cut federal spending. As small business men and women we have had to streamline our businesses and become more efficient in the delivery of our products to our customers. We believe the federal government should do likewise and we are disappointed that the President's economic recovery package fails to include greater levels of cuts.

However, we also recognize that even with steep budget cuts, additional revenue may be needed in order to bring the deficit back in line. To this end we believe the most appropriate tax increases are those that are applied across our entire economic system so that everyone shares in the additional tax burden. Historically we have opposed energy taxes targeted at deficit reduction because we saw no correlation between the amount of energy one consumed and that individual's contribution to the deficit. We still believe no such correlation exists.

However, this year, in recognition of pressing deficit concerns, the association agreed to consider a broad based energy tax that was applicable to all fuels at the same rate. In fact, prior to the State of the Union address, the association was taking the necessary policy steps to support the President's economic recovery package on the assumption that such a broad base energy tax would be part of that package.

Unfortunately, the Btu tax actually proposed by the President contains a supplemental tax on oil which is more than twice the rate of tax imposed on any other fuel. While this supplemental tax raises general concerns over the fairness and equity of taxing oil at twice the rate of other fuels, it also presents very specific and very substantial problems for our members in the following several areas.

First, the supplemental tax gives an unfair advantage to natural gas and electricity in the highly competitive residential heating market. PMAA represents thousands of oil heat dealers

throughout the country who will be devastated if this tax is enacted. PMAA does not believe that providing natural gas an advantage particularly in residential heating is appropriate.

Obviously, providing a differential tax for home heating oil penalizes persons who heat with oil. It is patently unfair to make someone who heats with oil pay more taxes merely because of the type of heating system that they have. Further, oil heat is not a luxury, it is a necessity in the extremely cold areas where oil heat is predominant. Finally, this tax will be unavoidable for many homeowners with fuel oil heating systems, and a substantial body of evidence developed by consumer groups, environmental groups and the Brookhaven National Laboratory indicates that it is not economically or environmentally wise to switch to a different fuel to avoid this tax. This information is detailed below.

Before proceeding, it should be noted that home heating oil consumption throughout the country has fallen in recent years and that conservation has been a goal of the businesses that I represent as well as a goal of our customers. The Consumer Energy Council of America (CECA) in a recent report noted that between 1978 and 1987, the average oil heated home reduced consumption by 25 percent. These reductions resulted from improvements in the heating system, better insulation and consumer choice (turning the thermostat down). Thus, the record for oil heat customers and their drive to reduce consumption is one that should set the example for how the nation can conserve fuel.

The President's proposal in establishing a tax differential between oil and other fuels used for heating, such as electricity or natural gas, creates substantial inequities and unfairness. This tax will result in similarly situated neighbors paying substantially different amounts of taxes to reduce the deficit. A homeowner who has been weathering the recession, who may have children entering college, or who is barely making ends meet will not understand why he must pay more than his neighbor to reduce the deficit. His use of oil did not make the budget deficit worse, he has not received more government benefits because he heats with oil, and if he were to convert to natural gas or electricity, the budget deficit would not be improved. It seems clear that this person should not be forced to pay more than his fair share.

We understand that some see the differential tax as an incentive to spur consumers to switch from heating oil to natural gas. This is an ill-advised and misguided rationale. In many areas of the country, such a conversion is not possible, and is certainly not desirable. Switching from one heating fuel to another does nothing to improve this nation's energy security. In fact, a switch from heating oil to natural gas may actually increase the amount of energy consumed, since, according to the Department of Energy, natural gas furnaces in use are generally less efficient than heating oil furnaces.

If this supplemental tax on oil does encourage consumers to spend $3,000 to switch fuels, the actual conversion cost may be a total waste. If the gas furnace is as efficient as their oil system, and if the prices for the two fuels differ only to the extent of the tax, the consumer may save $40 to $50 in federal taxes. As a result of the $3000 expenditure, total fuels consumption is not altered and the actual heating bill will fall only slightly. If instead, the homeowner was encouraged to invest in better insulation, he might spend between $1,000 and $3,000, but he would then reduce his consumption of fuel by 15 percent of more. Thus, actually saving oil or gas, and thereby increasing energy security.

We have also heard that the supplemental tax on oil may be designed to accomplish environmental goals. Again, we feel that a differential tax on home heating oil may actually contravene those goals. Greenpeace in a study released in April 1992, "Natural Gas: Bridging Fuel? or Road Block to Clean Energy?" has indicated that:

"* Natural gas is not clean. It is in itself a global warming producing gas more than 60 times as powerful as carbon dioxide. It produces acid-rain and urban smog causing emissions.

* It is not easy to produce. It inflicts environmental degradation equivalent to that of oil production, . . . "

Like CECA, Greenpeace believes that conservation is the answer and they state that "The cheapest, most sensible way to avoid air pollution and global warming gas emissions from fossil fuels is to simply use less of them. Conservation and improved efficiency provide an enormous well of energy that now flows unused through our windows, tailpipes and walls".

A differential tax does not encourage conservation, it encourages fuel switching. If a partial objective of the energy tax is to improve the environment, each of the fossil fuels should bear an equal and fair tax that encourages conservation and helps to reduce the deficit.

The best way to improve energy security and the environment is to reduce consumption, and the best way to reduce consumption is through conservation. Applying an equivalent Btu tax on all fuels is likely to spur conservation of all fuels, and would not encourage wasteful expenditures to switch fuels. Therefore, PMAA believes an equivalent Btu tax not only will assist in the reduction of the budget deficit, but will also encourage conservation and thereby benefit the environment.

Another source of strong concern to PMAA members is the impact that such a tax will have on farmers. PMAA members are primary suppliers of fuel for many agricultural communities throughout the

country. The standard Btu tax will increase the cost of fuel three and a half cents per gallon, and the supplemental tax will increase the cost four and a half cents per gallon for a total increase of eight cents per gallon.

The American Farm Bureau estimates that for a typical corn farmer raising 430 acres of corn, the direct impact of these fuel costs will be $550 per year. For the farmer, this may be a significant burden. Like every part of this country and nearly every citizen, the farm belt and its farmers have been harmed by the recession. Imposing another cost on this industry, above and beyond what other fuel users will have to pay, may slow the recovery in this important and vital industry and may affect their ability to compete in the international marketplace.

For the petroleum marketer who supplies the farmer, such a tax may substantially increase his accounts receivable, since in many cases the marketer may not collect the revenue from fuel sales during the planting season until after the harvest. This will place substantial new credit demands on both the farmer and the marketer.

If the supplemental tax is an environmental tax or is designed to reduce air pollution from automobiles and trucks, farmers should certainly not be responsible for paying for it. There is very little farming in Los Angeles, Chicago, New York and the other cities with severe air pollution problems. Most farmers are operating in areas defined by EPA as being in attainment of Clean Air standards, and their use of diesel fuel or gasoline does not create the type of air pollution problem that Congress addressed in the Clean Air Act. If a gasoline tax or an energy tax is an effective way of reducing air pollution, then the cities or regions with unhealthy air should levy the tax. A uniform federal tax makes too many people who live and work in rural areas pay for an urban problem.

The third major part of our customer base are truckstops and trucking companies. This tax will substantially increase fuel costs for these customers. Since, 1991, this industry has contributed two and a half cents per gallon for deficit reduction, a contribution unmatched by most industries. The proposed tax will increase the contribution by approximately eight cents per gallon. PMAA would note that the "just in time" delivery system has improved America's ability to compete, and that this system is largely based on the ability of trucking companies to deliver inventory needs on a very tight schedule at reasonable prices. We do not think that this industry should be singled out and required to again pay a bigger share to reduce the budget deficit.

Finally, our biggest and perhaps most important customers are those who purchase gasoline for their own motor vehicles. Everywhere in the country, gasoline is used by private motorists. We are deeply concerned that a tax of eight cents per gallons will substantially constrain their budgets, and believe that the more

moderate tax which would result from a uniform Btu tax would be fairer to these customers.

PMAA strongly believes that the Btu tax should be levied equally on all fuels, and if the tax is modified to that end, PMAA is likely to support such a tax. Deficit reduction is critical and is clearly in the national interest. However, differential tax rates on fuels are likely to result in substantial monies being wasted in the private sector as industries make investments to switch fuels to avoid a tax, rather than making the important investments which would reduce fuel use. These expenditures are non-productive, do not enhance productivity, and may in fact lessen our international competitiveness. We therefore strongly encourage the Committee to adopt a fuel neutral Btu tax.

PMAA also does not believe it is appropriate for the tax to be indexed. The Constitution vests the Congress with the taxation power, and even specifies that revenue raising bill should originate in the House. An indexation approach would vest within the Executive Branch the ability to determine what the actual tax rate will be, which we believe is an inappropriate delegation of authority.

From a policy standpoint, indexing is also unwise since it would allow the differential tax of oil, and all the problems associated with that differential tax, to grow. For example, had the tax been imposed five years ago and been indexed to the GDP deflator, the differential tax on oil today would be 41.2 cents per million Btu's, 7 cents higher than the current differential. Indexing not only locks in the differential, it exacerbates it.

Further, we are concerned that this tax may have many unintended consequences which will not be obvious until the tax is fully implemented. Allowing the tax to increase without Congressional oversight is therefore inappropriate. If the tax needs to be adjusted in three years, we believe that Congress should make the decision then as to how it should be adjusted.

At a minimum, if the differential remains in the final package, petroleum should not be subject to the indexing provisions thus allowing the competing fuels to gradually "catch up" with the tax rate on oil.

If this Committee does believe a differential tax on petroleum is appropriate, we strongly believe that heating oil and off-road users such as farmers should be exempt from the oil supplement. We do not believe that there are any sound economic or environmental reasons for an additional tax levy on oil heat customers or farmers. While providing an exemption for oil heat and off-road users may complicate the administration of the tax, it is necessary to provide equity between consumers and between regions of the country. PMAA is confident that a tax system can be designed which can effectuate these exemptions without

compromising the integrity of the tax and which may also improve the collection of the existing tax on motor fuels.

A final concern relates to how the tax is collected, and who should be responsible for paying the Btu tax. PMAA has been pleased to note that Treasury in its testimony to the various Congressional committees has indicated that the Btu tax will be imposed on petroleum products leaving the refinery. PMAA believes that this approach is superior to taxing the crude oil entering the refinery for a number of reasons, including trade policy and overall industry competitiveness.

However, we believe that there continues to be a number of issues that must be resolved and that should be considered by the Committee. As you know, the lighter petroleum products distributed by our members are subject to many federal and state excise taxes. For gasoline, the point of collection is generally the point where gasoline breaks bulk and leaves the terminal. For diesel, the point of collection is the producer level, and generally is the point where the product is identified as being for a taxable purpose or not.

The Committee is well aware that the collection of diesel and gasoline taxes has been plagued by fraud and evasion for many years. As a result, Congress has had to continuously revise the tax laws to stem these problems. Each change has solved some problems, and often created new problems. Unfortunately, we continue to receive reports that problems with taxation of motor fuels still exists, and we therefore would encourage the Committee to examine whether it might be appropriate to piggyback a Btu tax system onto an improved motor fuels tax system, rather than develop a new tax system for these products.

We thank you for providing us the opportunity to testify on this important tax proposal, and would gladly respond to any questions that you may have.

Mr. ANDREWS. Mr. Ames.

STATEMENT OF EUGENE L. AMES, JR., CHAIRMAN OF THE BOARD, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA AND PRESIDENT, VENUS OIL CO., SAN ANTONIO, TX

Mr. AMES. Thank you, Mr. Chairman. My name is Eugene L. Ames, Jr. I am a petroleum geologist and president of Venus Oil Co., a small natural gas exploration company in San Antonio, TX, and I serve also as chairman of the Independent Petroleum Association of America.

Natural gas and crude oil provides 65 percent of our Nation's energy, yet today we have a collapsing domestic natural gas and oil industry. Did you realize that the Department of Energy projects that, with current depressed conditions in the domestic energy industry, foreign oil imports would rise to the point where we can expect 34 supertankers a day sailing into America's harbors loaded with foreign oil in a few short years with a huge risk of major oil spills and an intolerable burden on our economy?

Drilling for natural gas and oil hit all time lows last year in this country, and this year looks no better. Let me remind everyone that lest we forget there was an historic collapse in the world price of oil in 1986 when prices fell more than 60 percent. American domestic producers were devastated. A record number of bankruptcies resulted and over 450,000 jobs were lost in 33 oil producing States.

Investment capital has deserted independent producers. The major oil companies are moving their exploration activities overseas, and moving jobs overseas, where governments provide support of their activities and access to lands favorable for oil and gas.

The tragedy of these unfortunate consequences is the United States possesses a recognized vast undeveloped resource of natural gas and large remaining reserves of crude oil. But this disastrous course does not need to continue. If our domestic oil industry could be turned loose and put back to work, the situation could be turned around, but the Btu tax will not do this. The Btu tax will subsidize foreign oil imports and will reduce domestic oil production.

We are, however, pleased that Secretary of the Treasury Lloyd Bentsen and others in the administration have been willing to meet with the industry and consider our concerns. If the collection point is on the producer, most oil and gas wells in this country would likely be uneconomical. We are hopeful the collection point issue and other serious problems involving the tax on energy used to produce energy will be resolved if, in fact, there is to be a Btu tax.

In the meantime, much of the domestic industry has come to a halt. Wells are not being drilled, long-term gas sales contracts are not being signed. And at risk are the surviving independent producers who produce 60 percent of our natural gas and 40 percent of our oil. And let me state that most independents are small, family-owned sole proprietorships like my own.

My family has been an independent producer since 1913, when my grandfather, who was a wheat farmer in Oklahoma, moved to Drumright and drilled an oil well. I have two sons and a son-in-

law in business with me, a geologist, a lawyer and a land man. If we had outside capital, we could expand our business and could continue in this business, for several generations, possibly.

The collective strength of the thousands of independents like me could make a substantial contribution to our Nation's future energy needs and we could create hundreds of thousands of jobs in the process.

Our domestic natural gas and oil wells constitute a national treasure. Contrary to popular opinion, most of our lower 48 gas and oil wells are high cost, barely economical wells. The average oil production from oil wells located in the lower 48 States is only 9.84 barrels per day. Marginal oil wells, however, collectively, produce more oil than we import from Saudi Arabia.

Please, Mr. Chairman and committee members, as you debate steps which will expedite the rebuilding of America's economy, please remember the devastated American petroleum industry. I ask that you consider adopting fiscal policies which will preserve the important resource which is our domestic oil and gas wells.

When President Clinton spoke to the Nation in mid-February, he told the American people that the real engine of economic growth in this country is the private sector. We agree and we want to add that the domestic oil and natural gas industry provides the fuel for that engine.

Thank you very much.

[The prepared statement follows:]

Statement by
Eugene L. Ames, Jr.
Chairman of the Board
Independent Petroleum Association of America
Before the
Committee on Ways and Means
United States House of Representatives

March 23, 1993

MR. CHAIRMAN AND MEMBERS OF THE WAYS AND MEANS COMMITTEE:

The United States economy is fueled by energy. Certainly without the energy provided by our domestic energy industry our nation would have never grown to be the greatest nation in the world.

Natural gas and crude oil provides 65% of our nation's energy. Yet today we face the collapse of the domestic natural gas and oil industry.

Our nation's appetite for natural gas and crude oil will continue to increase in the future. In 1992, our demand for oil was almost 18 million barrels per day and 46% of this demand was supplied by foreign oil imports. If current trends continue we could be importing the 17 million barrels of petroleum each day by the year 2010.

We have the natural gas resources and plenty of oil resources to significantly reduce future foreign oil imports. Independent producers who currently produce about 60 percent of domestic natural gas and about 40 percent of domestic oil are eager for economic conditions which would allow us to increase domestically produced supplies of natural gas and oil. Yet drilling for natural gas and oil hit all time lows last year and this year looks no better.

Lest we forget, let us recall that because of Saudi Arabia's desire to regain control of world oil markets in 1986, there was a collapse in the world price of oil of more than 60 percent. American domestic producers were devastated. A record number of bankruptcies resulted and over 450,000 jobs were lost in 33 oil producing states.

Since this collapse, extremely volatile swings in price and the threat of future price collapses has blocked investment capital from independent producers. The major oil companies are understandably moving their exploration activities overseas, where governments provide support and access to favorable oil and gas lands.

The tragedy of these unfortunate consequences is that the United States possesses a recognized vast undeveloped resource of natural gas as well as large remaining oil resources. But, the Energy Information Agency predicts that U.S. oil demand could rise from 17 million barrels per day in 1990 to 23 million barrels per day in 2010, and that if low oil price trends and the current economic conditions persist. Domestic oil wells would decrease their production from over 7 million barrels per day in 1990 to only 3 1/2 million barrels per day in 2010, and imports would increase from 8 million barrels per day to over 17 million barrels per day by 2010.

This disastrous course would mean more than 30 supertankers a day sailing into America's harbors in a few short years...a huge risk of major oil spills, and an intolerable burden on our balance of payments.

This situation can be reversed if our domestic oil industry is turned loose and put back to work. The BTU tax will not do this. The BTU tax, as proposed, will subsidize foreign oil imports and will reduce domestic oil production further. If there must be an energy tax, the collection point must be moved because collection at the wellhead would bankrupt the remaining core of a beleaguered industry.

We are pleased that Secretary Lloyd Bentsen and others in the Administration have been willing to meet with us and consider our concerns. It has been a very constructive dialogue. And we are hopeful that "collection point" issues have been reexamined, and that the Administration is now focused on downstream

collection of the BTU tax. But, while the dialogue and consideration of the details of the tax are underway, much of the domestic industry has come to a screeching halt-- wells are not being drilled, long-term sales contracts are not being signed, plans for energy consuming plants and businesses have been put on hold.

Now, the collection point is not the only problem we have the proposed BTU tax. Clearly, there is no justification for a double tax on oil. It falls equally on domestic and imported oil and will <u>not</u> decrease our nation's oil import dependence one iota. Furthermore, to the extent that the BTU tax is levied on the energy used to produce energy, it will increase the costs of incremental and advanced oil and gas recovery and thus decrease domestic energy production.

Most independent are small, family-owned sole proprietorships. My family have been independents since 1913 when my grandfather was a wheat farmer in Oklahoma and he drilled an oil well in Drumright, Oklahoma. I have two sons and a son-in-law in business with me. A geologist, a lawyer and a landman. If we had outside capital we could expand our business, and my family could continue in this business for future generations. With the collective strength of thousands of independents like me, we could make a substantial reduction in out nation's future foreign oil imports and we could create hundreds of thousands of jobs. However, because of the volatility of our markets and the uncertainty of the financial effects of the proposed BTU tax, there is little capital available from the financial markets.

If this situation continues, the energy production industry in the United States will be history in a few short years. Small companies like mine will disappear and the large independents and major oil companies will be forced to go overseas to drill.

Our domestic natural gas and oil wells constitute a national treasure. Most of our lower 48 gas and oil wells are high cost marginal wells which collectively produce more oil than we import from Saudi Arabia. Congress must consider ways to save this vital segment of our domestic energy supplies.

When President Clinton spoke to the nation before a joint session of Congress in mid-February, he told the American people that the real engine of economic growth in this country is the private sector. We agree, and we want to add that the domestic oil and natural gas industry provides the fuel for that engine.

President Clinton said his priority is to create jobs...that there's no recovery worth its salt that doesn't put the American people back to work. We agree. We want to put back to work many of the nearly 450,000 people who have lost their oil and natural gas hobs in the past decade. That's nearly as many jobs as the President hoped to gain in his initial economic stimulus package.

I applaud this committee, Mr. Chairman, which last year recognized the need to provide tax policy changes to shore up the domestic industry in last year's Energy Policy Act. The AMT reforms were sorely needed and greatly appreciated. However, I must point out that much of the benefit of those changes has been wiped out by the fall in oil prices. Further erosion is inevitable under the higher AMT rates proposed in the Administration's economic plan. More must be done.

That brings me to the critically important issue of our nation's marginal well production. Marginal wells -- those that daily produce less than 15 barrels of oil and 90 thousand cubic feet of gas -- are essential to our domestic energy supply. Marginal wells provide at least and probably considerably more than 20 percent of domestic oil production and 13 percent of our gas production. <u>Congress must consider ways to improve the economics of investment in this vital segment of our domestic energy supplies.</u>

Please, Mr. Chairman and committee members, take the steps necessary to promote rebuilding of our economy, and don't forget the depressed and devastated American domestic petroleum industry as you execute your critical share of the responsibilities of our government. Thank you.

Mr. ANDREWS. The point I would like you to address in the first 5 minutes here is this issue of the collection point that Mr. Ames just mentioned.

Vic, we have talked about this several times. Give us your thoughts about why that is significant, why it is important. Assume for the sake of this discussion, that there is going to be a Btu tax. In your judgment how can we best encourage production and preserve the energy by setting a correct collection point?

Mr. BEGHINI. Mr. Chairman, if you will look at the flow chart up here, you can see we have a very complex system in the oil and gas industry as we move from place to place to get to the ultimate consumer.

If we put it back at the producer, this tax, as structured, is a production tax. It is not a consumption tax. There is a great chance that most of this tax will not be passed through to the ultimate consumer, because of global competitiveness from refined products and other crudes from around the world.

As you move this tax closer to the rack, for example, two things happen: First, is you are getting closer to the ultimate consumer.

Mr. ANDREWS. You will have to tell us all what the rack is.

Mr. BEGHINI. That would be at the product terminal, or where you break bulk, and that is where the excise tax is currently collected, I might add.

As you move it closer, you escalate your chances of recovering this tax if you are in this business. The other thing that you do that is very important, is that at that point you know what the final disposition of those products are going to be; whether they are going to go to a petrochemical plant for exempt use, or whether they are going to some other utility service for a particular exemption, and you will be able to more easily define and audit the collection of the tax at that point.

Beyond that, at every step of this flow chart you will notice it takes energy; energy to produce, energy to compress, energy to transport, and energy to make individual products. The imported product that comes in to this country, which the domestic refiner must face as competition, bears none of those costs. So, as a result, the domestic refining industry will be placed in a very, very untenable position as we try to compete for refined product markets.

If it fails to collect these taxes from the consumer, it has two choices: Either the industry must eat those taxes, that industry being the refiner, or it must look to the producer to collect those costs, which means it reduces the posted price of crude oil. And that, Mr. Chairman, is why the collection point is so very, very critical in this tax, in both the liquid and the natural gas side.

Mr. ANDREWS. Mr. Terry, do you want to add something to that?

Mr. TERRY. Yes. The point of collection is, obviously, crucial, and you might think that as a representative of an LDC, I would like to see it back at the wellhead. We have thought this through and that is not the case.

The best place to put it is on the ultimate consumer and collect it by the one selling the gas to the consumer. If it is our customer, we would collect the tax from that purchaser; if it is somebody else selling that gas to the ultimate buyers that we are transporting, they would collect the tax.

If you go back to the wellhead, you have thousands and thousands of producers, many of them very small. There would be real administrative problems for these people.

Second, the other problem is it gets into this question of, all along the line who might end up absorbing the tax. Would it be the producer at the wellheads or the LDC?

Now, absorb is a term that people are using but it is very deceptive because it sounds like somehow somebody is absorbing the tax and people are not paying it. Let us put the tax in our situation as an LDC. Let's say for some reason we ended up having to absorb some of that tax. What does that mean? These are big, big dollars. We cut capital programs. What does that mean? People lose jobs. We have to cut employment. People lose jobs.

Ultimately, people are going to end up paying, and it is much better to simply put the tax on the consumer and have the party selling that natural gas to the consumer collect the tax.

Also, you have the compounding problems that I mentioned. In a situation like Chicago, where you have energy taxes already imposed, if the Btu tax is collected at the city gate or further upstream, there would be a 14-percent additional tax due to compounding.

Mr. ANDREWS. If the Btu tax is eliminated and yet there is an energy component in the deficit reduction bill, is there a consensus among the four of you on what that should be?

Mr. BEGHINI. I guess I can start, Mr. Chairman. I believe a broad-based consumption tax, a VAT, is a logical place to try to get these revenues, if it is determined they are needed to fund the deficit.

Mr. ANDREWS. Excuse me just a second. Not any tax, an energy tax. If there is an energy component in the final package.

Mr. BEGHINI. I believe, though, that with a broad-based VAT, the energy industry is going to participate in that tax.

The energy industry will not escape a value-added tax. A credit invoice VAT will have all industries participate in that tax. All consumers will participate. But the one major thing it does is it keeps the playing field between domestic manufacturers and international manufacturers level. And the Btu tax would make us the only country in the world that disadvantages our own domestic manufacturing processes at the expense of international energy.

Mr. ANDREWS. I wonder if anyone else would like to contribute a suggestion of an energy component to replace the Btu?

Mr. TERRY. Again, AGA favors a national consumption tax before we get to an energy tax. But if we have to have a separate identifiable energy component, we would prefer, then, to see a tax on imported oil or gasoline.

Mr. ANDREWS. Mr. Ames.

Mr. AMES. We don't want any energy tax.

Mr. ANDREWS. I understand that. I understand that the——

Mr. AMES. It makes it very difficult to——

Mr. ANDREWS. That is fairly clear. We understand that part.

But just assume for a moment that the administration and the Congress have mandated that the Ways and Means Committee and the Senate Finance Committee have an energy component in the

deficit reduction package. Would you prefer or would you tell us what other energy tax you would prefer to a Btu tax?

Mr. AMES. Well, I can't say I would prefer any other consumption tax to a Btu tax because they are all just about as bad. But I think that I would have to say that I would prefer the value-added tax. A broad comprehensive value-added tax. IPAA, of course, supports an oil import fee.

Mr. ANDREWS. Mr. Woosnam.

Mr. WOOSNAM. We can support the Btu tax, but it must be equal taxation on all fuels without preferential treatment.

Mr. ANDREWS. Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Gentlemen, I appreciate your testimony and I think it has been very helpful to the committee. Following up a little bit on the point of collection, Mr. Beghini, I expect there will be a number of exemptions to this Btu tax that will be authored in amendment form if not presented by the administration. One of the difficulties we have is we haven't seen any details at this point. So, it is difficult to even ask you any questions until we have seen the details. But we know that the Secretary has said that chemical feed stocks will be exempt.

Now, considering that there may be other exemptions, does that make it even more important as to the point of collection as far as administering this particular tax?

Mr. BEGHINI. Absolutely, Mr. Archer. As I say, you need to make sure that if you are going to exempt at the point of collection, it has that exemption very well defined so you don't have an audit problem. As you move this tax collection point downstream to where this becomes more definite and definable, then these exemptions will be able to be looked at more openly and we will have a better chance from an administrative and auditing standpoint of being able to be tracked.

Mr. ARCHER. You mentioned in your testimony that this would be a tax on fuel used to produce fuel. Can you tell the committee any differentiation between an industry, say, aluminum or paper, which has got to bear the tax and the refiners who also have to bear the tax?

Mr. BEGHINI. In fact, we do believe that this is an onerous tax on all manufacturing processes. The imbedded fuel costs will have a negative effect on all manufacturing in this country. The one single difference we believe that sets the oil industry apart is that we are being taxed on a fuel component that is used to make fuel.

For example, in California, in heavy crude oil production that uses steam as the recovery process, they are burning a barrel of that oil or buying natural gas to basically get three barrels of oil out of the ground. That effectively would add $3.50 a barrel to the cost of a product which currently in California is in the $10 range.

In that environment, you basically would shut in a major part of the steam flood operations in California. That also would apply in areas where you have gas injection projects, where you are injecting gas into the reservoir. It would apply in areas where a lot of the independents and majors have wells that are very high water cut and take a lot of electricity and energy to get the oil out of the ground. We believe that is a tax on a tax, and double taxation.

Mr. ARCHER. It seems to me from your answer that that would particularly increase the importation of foreign oil by reducing the amount of oil and gas we produce domestically.

Mr. BEGHINI. Yes, sir, it would. In fact, I think this country would be a lot better off if it devoted more energy, if you will excuse the pun, to making domestic energy and less in trying to see what we can do to domestic energy.

Mr. ARCHER. Let me ask each of you a question as to what you believe the impact will be on the economy from this Btu tax insofar as we understand it today. What particularly will be the impact on jobs over the next 5 years?

I am talking about domestic jobs; I am not talking about the jobs that are exported overseas by forcing industries to move their plants overseas. I am talking about jobs in the United States of America.

Mr. BEGHINI. Well, the models we have run at the API have suggested that this tax by 1998 will reduce the GDP by $34 billion on an annual basis, and will cost the country 400,000 jobs.

Mr. ARCHER. Do any of the rest of you have an analysis on the projected impact of this tax?

Mr. AMES. If the tax as originally proposed at the oil wellhead and upstream for gas, if that were to happen, I mean, you would see several hundred thousand jobs in the oil and gas production industry lost, in my opinion.

Mr. WOOSNAM. In our industry, because of the way the tax is currently being proposed, there would be tremendous loss of jobs in the retail home-heating oil business through conversions to other fuels because of their preferential treatment.

Mr. TERRY. AGA has not come up with a specific number, and it is going to vary somewhat depending on how this tax ends up getting imposed and the point of collection. For instance, if it ends up being on LDC's and we are forced to absorb some of the costs, that would mean we would have to cut capital expenditures. I just went through that scenario in our case and we would have to absorb $20 or $30 million. We estimate that $60 to $70 million would be paid by consumers in Chicago for this tax. That amount is just in the city of Chicago. These dollars would be coming out of that local economy. This is going to cost some jobs someplace along the line. I cannot give you a number, but that is just a microcosm of the whole economy.

Mr. ARCHER. Does this not seem counterproductive to the goal that we are striving to reach in this country for deficit reduction and helping this country to be more competitive in the world marketplace?

Mr. TERRY. I would certainly agree with that. The AGA's first position is focused on cutting expenditures before you go to taxes.

Mr. ARCHER. Gentlemen, thank you very much.

Mr. ANDREWS. Thank you, Mr. Archer.

Mr. Brewster will inquire.

Mr. BREWSTER. Thank you, Mr. Chairman.

I think some significant points were made by this panel. Mr. Ames, you mentioned that your family started in the oil business in 1913 in Oklahoma. I don't know if you are aware, but in 1992, Oklahoma produced less oil than any years since 1919. We have

lost somewhere between 60,000 and 80,000 jobs in Oklahoma alone, and are certainly not the significant producer that we once were. So I think you made some valid points.

Mr. Terry, you mentioned that certainly you would like to see a tax on imported oil. Mr. Terry, I would like to see that, too, but I think that has been tried around the track a few times and I suspect that that is not a possibility at this particular point.

My friend, Mr. Archer, mentioned in several—or asked several of our witnesses today, in the past, if there is any other manufacturing country in the world that taxes energy to their manufacturers.

Is there any other manufacturing, significant manufacturing country in the world that is a significant producer? Germany and Japan are certainly not significant producers of energy. Korea?

Mr. BEGHINI. No.

Mr. BREWSTER. So really, all these people operate principally on imported oil. Do their manufacturers sustain any taxation or what on the imported oil coming into their countries?

Mr. BEGHINI. Most of those have a value-added tax such that those manufacturers on any exports are kept whole through the ability to deduct those taxes.

Mr. BREWSTER. Mr. Woosnam, I know, too, the industry that you are in has had significant problems in the past with collections, especially on diesel fuel for off road, those types of things. Assuming there is an energy component to this particular tax program, is this an opportunity to clear up some of the collection points in your current problem in that regard?

Mr. WOOSNAM. We believe that we can work with the committee to come up with a system that helps protect the collection process and enhance the revenues that would be derived from it.

Mr. BREWSTER. So the terminal rack is the proper collection point, in your opinion?

Mr. WOOSNAM. We believe so.

Mr. BREWSTER. Mr. Beghini, you are familiar I guess with the recent announcements in the United Kingdom of a value-added tax just on energy.

Mr. BEGHINI. Yes, sir, I am. As a matter of fact, the United Kingdom did just recently extend the VAT to energy consumption which heretofore had been excluded.

The other interesting thing that the United Kingdom did at the same time was this: They have a tax called the petroleum revenue tax, which basically says that you will pay a tax rate of 75 percent on your income after you have recovered 130 percent of your capital investment. It is interesting to note that the United Kingdom's new tax rules have decreased that tax from 75 percent to 50 percent for all existing fields and completely eliminated that tax for all new fields.

So it appears to me that the United Kingdom is working very hard to husband and grow their energy industry and those people employed in that industry while taxing the utility of fuels at the consuming level, not at the production level such as the Btu tax.

Mr. BREWSTER. Very good. Thank you.

Mr. ANDREWS. Thank you, Mr. Brewster.

Are there other members that would like to inquire?

Mrs. JOHNSON. No questions.

Mr. ANDREWS. I would like to thank the panel for the valuable contribution you have made. We will certainly take all of this information into consideration as we continue our deliberations.

The next next panel is made up of Gerald Alderson, who is with the Business Council for a Sustainable Energy Future; Robert Hauptfuhrer with the Natural Gas Supply Association; Ellen Roy, with the National Independent Energy Producers; Dennis Sabourin, with Wellman, Inc.; and Daniel Lashof, with the Natural Resources Defense Council.

I want to welcome this panel and thank you very much for being here with us this morning, and we will enter your testimony into the record, your written testimony, and you may proceed with your oral testimony. I would ask Mr. Alderson to begin, if you would.

STATEMENT OF GERALD ALDERSON, VICE CHAIRMAN, BUSINESS COUNCIL FOR A SUSTAINABLE ENERGY FUTURE, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, KENETECH CORP., SAN FRANCISCO, CA

Mr. ALDERSON. Thank you and good morning, or good afternoon. I appreciate the opportunity to be here today.

I am the president and chief executive officer of Kenetech Corp., which is a fully integrated energy service company based in San Francisco. We design, finance, operate, and maintain a variety of powerplants which typically utilize environmentally preferred technologies, namely wind, biomass and natural gas, in virtually all of our activities.

We also provide conservation and energy management services to our customers. It is also the case that our windpower subsidiary is far and away the largest such entity in the world.

In my capacity here today, I am speaking as vice chairman of the Business Council for a Sustainable Energy Future. This is an organization comprised of business leaders from the energy efficiency, renewable energy, natural gas, and utility industries who share a common commitment to the view that a new energy strategy for the 1990's and beyond is possible.

Essentially, that strategy contemplates the rapid deployment of efficient and low or nonpolluting energy technologies, expanded reliance on energy efficiency, and renewable energy and natural gas as the three bases upon which to implement that system.

To achieve this end, the business council supports related policies and programs at the Federal and State level which are consistent with those articulated objectives; that is, improve energy efficiency; accelerate the commercialization of renewable energy sources; and promote the use of natural gas.

We are pleased with the prominent role that President Clinton has given to these three pillars of energy policy in fashioning his economic policies. Although we have interests in many of the provisions of the administration's proposed package, my testimony will focus on the revenue portion of that package and, in particular, the broad-based energy tax.

In addition, I will also briefly address a concern we have about the implications for the proposed investment tax credit, something which I haven't heard mentioned much here this morning, as to how it would be implemented under current law. We believe that

that current tax policy may inadvertently reduce or eliminate many of the benefits that are proposed in President Clinton's package.

As part of the deficit reduction portion of his economic package, President Clinton has proposed a broad-based energy tax designed to raise approximately $20 billion annually when fully phased in. According to the administration, in addition to raising revenues, such taxes will encourage conservation by making energy more expensive, reduce pollution and decrease the country's dependence on foreign energy suppliers.

We clearly support these goals. However, there are many types of taxes that offer the opportunity to raise revenue while also serving the energy and environmental policies noted above.

While several of our members may have preferred other formulations, we recognize that no approach is without criticism, and therefore, we are prepared to support a broad-based Btu energy tax in recognition that it is an important step in the direction of a sustainable energy future. In particular, we applaud the exclusion of renewable energy resources from the tax.

The council's support for this tax is not without reservations, however. First, when the tax is phased in, it will result in only modest improvements in encouraging energy conservation. In this regard, it may be appropriate to provide energy tax credits. And second, we believe that it should be structured such that it is collected closer to the end use of the energy sources.

Finally, the business council is particularly concerned with the proposed collection point for natural gas. We think that it is best to collect that gas at the end-use point rather than the inlet to the pipeline.

I think in general in our comments as they relate to the investment tax credit, many of our points are specific and detailed, and we would propose to work with the committee's staff in their implementation.

With that, I would again like to thank you for the opportunity to define this position this morning, and will look forward to questions later.

[The prepared statement follows:]

THE BUSINESS COUNCIL'S
VIEWS ON THE PRESIDENT'S
ECONOMIC PACKAGE

REMARKS BY GERALD ALDERSON
VICE-CHAIRMAN
BUSINESS COUNCIL FOR A
SUSTAINABLE ENERGY FUTURE

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
MARCH 23, 1993

I. INTRODUCTION

GOOD MORNING. I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY. I AM GERALD ALDERSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF KENETECH CORPORATION. KENETECH CORPORATION IS A FULLY-INTEGRATED ENERGY SERVICE COMPANY BASED IN SAN FRANCISCO, CALIFORNIA. KENETECH'S SUBSIDIARIES DESIGN, BUILD, FINANCE, OPERATE AND MAINTAIN POWERPLANTS WHICH UTILIZE ENVIRONMENTALLY PREFERRED TECHNOLOGIES-PRINCIPALLY WIND, BIOMASS, AND NATURAL GAS. THE CORPORATION ALSO PROVIDES ENERGY CONSERVATION AND MANAGEMENT SERVICES TO CUSTOMERS. KENETECH'S WINDPOWER SUBSIDIARY IS THE LARGEST DESIGNER, CONSTRUCTOR, AND OPERATOR OF WINDPLANTS IN THE WORLD. I AM HERE TODAY IN MY CAPACITY AS VICE-CHAIRMAN OF THE BUSINESS COUNCIL FOR A SUSTAINABLE ENERGY FUTURE.

THE BUSINESS COUNCIL FOR A SUSTAINABLE ENERGY FUTURE IS A NEWLY CHARTERED ORGANIZATION COMPRISED OF BUSINESS LEADERS FROM THE ENERGY EFFICIENCY, RENEWABLE ENERGY, NATURAL GAS AND UTILITY INDUSTRIES THAT SHARE A COMMITMENT TO PURSUE A NEW ENERGY STRATEGY FOR THE 1990S AND BEYOND. THIS NEW STRATEGY IS DESIGNED TO REALIZE THE NATION'S ECONOMIC, ENVIRONMENTAL AND NATIONAL SECURITY GOALS THROUGH THE RAPID DEPLOYMENT OF EFFICIENT, NON- AND LOW-POLLUTING ENERGY TECHNOLOGIES. THE EXPANDED RELIANCE ON ENERGY EFFICIENCY, RENEWABLE ENERGY AND NATURAL GAS AS THE THREE PILLARS OF AN ENERGY STRATEGY WILL STRENGTHEN THE ECONOMY AND ENHANCE THE ENVIRONMENT.

TO ACHIEVE THIS END, THE BUSINESS COUNCIL SUPPORTS ENERGY RELATED POLICIES AND PROGRAMS AT THE FEDERAL AND STATE LEVELS THAT: (1) IMPROVE ENERGY EFFICIENCY IN ALL SECTORS OF THE ECONOMY; (2) ACCELERATE THE COMMERCIALIZATION OF RENEWABLE ENERGY RESOURCES; AND (3) PROMOTE THE USE OF NATURAL GAS IN ENERGY PRODUCTION AND END USE.

THE BUSINESS COUNCIL IS PLEASED WITH THE PROMINENT ROLE PRESIDENT CLINTON HAS GIVEN TO ENERGY EFFICIENCY, RENEWABLES, NATURAL GAS AND THE REDUCTION OF OIL IMPORTS IN FASHIONING HIS ECONOMIC PACKAGE. WE BELIEVE THAT THIS PACKAGE SIGNALS A MAJOR CHANGE IN NATIONAL ENERGY POLICY--THE RECOGNITION OF THE NEED TO TRANSITION TO CLEAN, EFFICIENT ENERGY SOURCES. THE BUSINESS COUNCIL WELCOMES THIS CHANGE IN DIRECTION.

ALTHOUGH WE HAVE INTERESTS IN MANY PROVISIONS OF THE ADMINISTRATION'S PROPOSED ECONOMIC PACKAGE, MY TESTIMONY TODAY WILL FOCUS ON THE REVENUE PORTION OF THE PACKAGE AND, IN PARTICULAR, THE BROAD-BASED ENERGY TAX.

IN ADDITION, I WILL ALSO ADDRESS BRIEFLY A CONCERN WE HAVE ABOUT THE IMPLICATIONS OF THE PROPOSED INVESTMENT TAX CREDIT AS IT WOULD BE IMPLEMENTED UNDER CURRENT TAX LAW. WE BELIEVE THAT CURRENT TAX POLICY MAY INADVERTENTLY REDUCE THE BENEFITS OF THE INVESTMENT TAX CREDIT FOR CERTAIN INDUSTRIES THAT NEED IT THE MOST.

II. ENERGY TAXES:

AS A PART OF THE DEFICIT REDUCTION PORTION OF HIS ECONOMIC PACKAGE, PRESIDENT CLINTON HAS PROPOSED A BROAD-BASED ENERGY TAX DESIGNED TO RAISE MORE THAN $20 BILLION ANNUALLY WHEN FULLY PHASED-IN. ACCORDING TO THE ADMINISTRATION, IN ADDITION TO RAISING REVENUE, "ENERGY TAXES WILL ENCOURAGE CONSERVATION BY MAKING ENERGY MORE EXPENSIVE, REDUCING POLLUTION, AND DECREASING THE COUNTRY'S DEPENDENCE ON FOREIGN ENERGY SUPPLIERS." THE BUSINESS COUNCIL CLEARLY SUPPORTS THESE GOALS.

THERE ARE MANY TYPES OF TAXES THAT OFFER THE OPPORTUNITY TO RAISE REVENUES WHILE ALSO SERVING TO SUPPORT ENERGY AND ENVIRONMENTAL POLICY OBJECTIVES. WHILE MEMBERS OF THE BUSINESS COUNCIL MAY HAVE PREFERRED OTHER FORMULATIONS, WE RECOGNIZE THAT NO APPROACH IS WITHOUT CRITICISM. THE BUSINESS COUNCIL IS READY TO SUPPORT PRESIDENT CLINTON'S BROAD-BASED ENERGY TAX PROPOSAL IN RECOGNITION THAT THE TAX IS AN IMPORTANT STEP IN THE DIRECTION OF A SUSTAINABLE ENERGY FUTURE. IN PARTICULAR, WE APPLAUD THE EXCLUSION OF RENEWABLE ENERGY RESOURCES FROM THE TAX.

THE BUSINESS COUNCIL'S SUPPORT FOR THIS TAX IS NOT WITHOUT RESERVATIONS, HOWEVER. FIRST, THE TAX, WHEN FULLY PHASED IN, WILL RESULT IN ONLY MODEST IMPROVEMENTS IN ENCOURAGING ENERGY CONSERVATION. IN THIS REGARD, IT MAY BE APPROPRIATE TO PROVIDE ENERGY TAX CREDITS TO CONSUMERS TO FURTHER ENCOURAGE ENERGY CONSERVATION. SECOND, WE BELIEVE THE ENERGY TAX COULD BE STRUCTURED TO MORE APPROPRIATELY REFLECT THE DIFFERENTIAL ENVIRONMENTAL AND ENERGY SECURITY IMPACTS OF VARIOUS ENERGY SOURCES. IN THIS REGARD, WE RECOMMEND THAT SERIOUS CONSIDERATION BE GIVEN TO ADJUSTING THIS TAX OVER TIME TO BETTER SUPPORT THE ADMINISTRATION'S OVERALL ENERGY AND ENVIRONMENTAL GOALS.

THIRD, THE BUSINESS COUNCIL HAS CONCERNS WITH THE PROPOSED COLLECTION POINT FOR THE TAX ON NATURAL GAS. THE ADMINISTRATION ORIGINALLY PROPOSED TO COLLECT THE TAX ON NATURAL GAS AT THE INLET TO THE PIPELINE SYSTEM. HOWEVER, APPLYING THE TAX AT THIS POINT WOULD EXPOSE THE NATURAL GAS INDUSTRY TO UNWARRANTED FINANCIAL RISKS ASSOCIATED WITH COLLECTING THE TAX, DUE TO CONTRACT AND REGULATORY CONSTRAINTS ON PASSING THE TAX ON TO THE ULTIMATE CONSUMER.

SIMILARLY, INDEPENDENT POWER PRODUCERS THAT USE NATURAL GAS TO GENERATE ELECTRICITY, IN SOME CASES, HAVE LONG-TERM POWER PURCHASE AGREEMENTS WITH PUBLIC UTILITIES THAT WOULD PREVENT THEM FROM PASSING ON THE INCREASED COST OF THE TAX. WHILE **THE BUSINESS COUNCIL DOES NOT ADVOCATE A SPECIFIC SOLUTION TO THE INDEPENDENT POWER PRODUCER ISSUE,** WE BELIEVE THAT ENERGY TAXES SHOULD BE IMPOSED IN SUCH A WAY SO AS TO MAXIMIZE THEIR ENERGY CONSERVATION AND ENVIRONMENTAL BENEFITS.

TO THE EXTENT THAT ENERGY TAXES ARE IMPOSED ON THOSE WHO ARE NOT THE USERS OF THE RESOURCE, THERE IS NO INCENTIVE TO INCREASE EFFICIENCY OR SUBSTITUTE CLEANER FUELS. THUS, THE ENERGY EFFICIENCY AND ENVIRONMENTAL BENEFITS OF THE TAX ARE DIMINISHED.

THE NATURAL GAS INDUSTRY HAS PROPOSED A SOLUTION TO THE COLLECTION POINT PROBLEM ON GAS WHICH THE BUSINESS COUNCIL SUPPORTS--THE TAX SHOULD BE ASSESSED ON THE END USER OF THE GAS AND COLLECTED BY THE SELLER. THIS APPROACH ENSURES THE REALIZATION OF THE FULL EFFICIENCY AND ENVIRONMENTAL BENEFITS OF THE TAX AND MINIMIZES UNINTENDED EFFECTS.

III. INVESTMENT TAX CREDIT

TURNING NOW TO THE INVESTMENT TAX CREDIT ISSUE, THE BUSINESS COUNCIL SUPPORTS THE INCENTIVES AND EXCLUSIONS PROPOSED AND ALREADY IN THE LAW FOR RENEWABLE ENERGY INVESTMENTS. HOWEVER, WE BELIEVE THAT SEVERAL ADDITIONAL TECHNICAL REVISIONS IN THE MANNER IN WHICH THE INVESTMENT TAX CREDIT OPERATES COULD FURTHER THE ADMINISTRATION'S OBJECTIVES IN PROVIDING AN INVESTMENT TAX CREDIT.

FIRST, WE URGE THAT THE AMOUNT OF THE ITC THAT CAN BE USED AGAINST THE ALTERNATIVE MINIMUM TAX BE INCREASED. EXISTING LAW LIMITS INVESTMENT TAX CREDIT UTILIZATION TO ONLY 25 PERCENT OF A COMPANY'S ALTERNATIVE MINIMUM TAX LIABILITY, REDUCING SUBSTANTIALLY THE VALUE OF THESE NEW CREDITS FOR MANY SMALL, START-UP COMPANIES AS WELL AS THE MAJORITY OF CAPITAL INTENSIVE INDUSTRIES THAT HAVE BEEN IN THE AMT TAX POSITION THROUGHOUT MOST OF THE RECESSION.

SECOND, MANY COMPANIES AND INDUSTRIES WILL RECEIVE A CONSIDERABLY REDUCED BENEFIT FROM A NEW INVESTMENT TAX CREDIT EITHER BECAUSE THEY ARE CURRENTLY SUBJECT TO THE ALTERNATIVE MINIMUM TAX, THEY HAVE UNUSED ITCS, OR THEY ANTICIPATE CONSIDERABLE ECONOMIC LOSSES ASSOCIATED WITH DEVELOPING NEW TECHNOLOGIES OR STARTING UP NEW HIGH-RISK BUSINESS VENTURES. FOR THESE COMPANIES, WE RECOMMEND THAT ANY INVESTMENT TAX CREDITS THAT WOULD OTHERWISE EXPIRE BEFORE USE DUE TO THE INTERACTION OF THE ALTERNATIVE MINIMUM TAX SYSTEM AND THE REGULAR TAX SYSTEM BE CONVERTED INTO ALTERNATIVE MINIMUM TAX CREDITS RATHER THAN BE LOST COMPLETELY.

THIRD, THE COUNCIL URGES THAT THERE BE NO REDUCTION IN THE PRODUCTION TAX CREDIT FOR WIND AND CLOSED-LOOP BIOMASS INVESTMENTS PROVIDED IN THE NATIONAL ENERGY POLICY ACT OF 1992 THAT WOULD OTHERWISE QUALIFY FOR THE INVESTMENT TAX CREDIT. CLEARLY, THESE INVESTMENTS REQUIRE THE FULL TAX BENEFITS TO

BRING THESE VALUABLE NEW ENERGY TECHNOLOGIES TO MARKET AND TO TREAT THEM SIMILARLY TO THE OTHER RENEWABLE TECHNOLOGIES. WE RECOMMEND EITHER THAT THE RESTRICTIVE LANGUAGE CONTAINED IN THE EXISTING PRODUCTION TAX CREDIT BE DELETED OR THAT THE IMPLEMENTING LEGISLATION OF THE INVESTMENT TAX CREDIT PROVIDE THAT THE PRODUCTION CREDIT NOT BE REDUCED FOR RENEWABLE ENERGY INVESTMENTS THAT OTHERWISE QUALIFY FOR THE INVESTMENT TAX CREDIT.

WE WOULD BE PLEASED TO WORK WITH COMMITTEE STAFF ON THESE ISSUES AND TO SUBMIT WRITTEN RESPONSES TO ANY TECHNICAL QUESTIONS THE COMMITTEE MAY HAVE.

IV. CONCLUSION:

THE BUSINESS COUNCIL APPRECIATES THE OPPORTUNITY TO ADDRESS YOUR COMMITTEE ON THE REVENUE MEASURES CONTAINED IN THE PRESIDENT'S ECONOMIC PACKAGE. WE SUPPORT THE PRESIDENT'S EFFORT TO TACKLE THE COUNTRY'S DEBILITATING BUDGET DEFICIT WHILE IMPROVING ENVIRONMENTAL QUALITY. AS BUSINESS LEADERS CONCERNED ABOUT THE HEALTH OF THE U.S. ECONOMY, WE BELIEVE THAT THE COUNTRY NEEDS TO FOLLOW A NEW ENERGY PATH-- FOR ECONOMIC, ENVIRONMENTAL AND SECURITY REASONS.

THE BUSINESS COUNCIL VIEWS THE PROPOSED BROAD-BASED ENERGY TAX AS A GOOD FIRST STEP IN ADDRESSING THE DUAL CHALLENGES FACING OUR COUNTRY--ECONOMIC REVITALIZATION AND ENVIRONMENTAL ENHANCEMENT. WE STAND READY TO WORK WITH BOTH THE ADMINISTRATION AND CONGRESS IN SUPPORT OF THESE EFFORTS.

THANK YOU.

Mr. ANDREWS. Thank you very much, Mr. Alderson.
Mr. Hauptfuhrer.

STATEMENT OF ROBERT P. HAUPTFUHRER, CHAIRMAN, NATURAL GAS SUPPLY ASSOCIATION, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ORYX ENERGY CO., DALLAS, TX

Mr. HAUPTFUHRER. Good morning, Mr. Chairman. I am Robert P. Hauptfuhrer, and I am chairman and chief executive officer of Oryx Energy Co. and chairman of the Natural Gas Supply Association.

Oryx is a Dallas-based natural gas and oil-producing company that is among the largest independents in the world.

The Natural Gas Supply Association is a Washington-based trade organization that represents domestic producers who market nearly 90 percent of the Nation's natural gas. Consistent with the administration's objective, NGSA's membership is commited to enhancing the country's use of natural gas.

We appreciate this opportunity to comment upon President Clinton's proposed economic package, and in particular upon the suggested Btu energy tax.

I will summarize my remarks but would ask that my entire statement be entered into the record.

Mr. ANDREWS. Without objection.

Mr. HAUPTFUHRER. Mr. Chairman, I would like to make three points.

First, we support President Clinton's goals of less Federal spending, meaningful deficit reduction and economic growth.

Second, the most constructive approach toward reducing the deficit would be larger cuts in Federal spending.

In 1969, when the Federal Government last had a balanced budget, tax revenues and Federal expenditures were about 19 percent of the gross national product. Last year, tax revenues were still 19 percent of the gross national product, but Federal spending absorbed about 25 percent.

Cutting expenditures is difficult and painful. I know. I know from firsthand experience.

Over the past several years, Oryx Energy has realigned, refocused and reduced costs to the extent that our work force is 40 percent smaller than just a few years ago.

My company and most American businesses have had no choice. To compete in today's increasingly aggressive international marketplace, companies must be more efficient than ever at providing goods and services, and I respectfully suggest the same is true for the Government.

We therefore applaud the efforts of the President and the House leadership to increase the spending cuts in the original proposal, but we would encourage you to do even more.

Finally, if policymakers decide the controls on Federal spending are insufficient, a broad-based consumption tax is preferable.

If such a tax is unacceptable, care must be taken in structuring the proposed energy Btu tax to ensure that is a consumption tax.

President Clinton and senior administration officials have stated their intent that the Btu tax be fully passed through to consumers.

Given the size of the energy tax and the President's proposal, it is essential that it not inadvertently become through faulty structuring a tax on production.

Specifically with respect to natural gas, the primary issue is where the tax is to be imposed, and as a result, who is the taxpayer and who serves as the collection agent.

To achieve the objective of the administration and ensure that the tax is levied on consumption, the tax should be imposed on the ultimate consumer. The last seller of that fuel should collect the tax. The members of the Natural Gas Council, an association which includes members of the American Gas Association, the Interstate Natural Gas Association of America, the Independent Petroleum Association of America and the Natural Gas Supply Association, agree that this is the proper point of collection if the tax is imposed.

Doing so minimizes the administrative burden, puts domestic and imported gas on an equal footing and avoids potential conflicts with other important government policies.

The imposition of the tax at any other collection point will result at a minimum in higher administrative costs, greater risk of tax avoidance and market distortions. There would also be considerable risk that not all of the tax would be passed through to consumers.

If portions of this tax fell to the natural gas industry, the damage could be significant. The economic health of the gas and oil producing industry is under severe stress. We have lost more than 400,000 jobs during the past decade. Our accumulative revenues from 1984 have dropped by more than $130 billion.

President Clinton and many in Congress have stressed their support for greater use of clean burning natural gas.

It would be tragic if the Btu tax were imposed in such a way that domestic gas supplies are reduced or the industry's ability to transport and distribute this clean burning fuel is impaired.

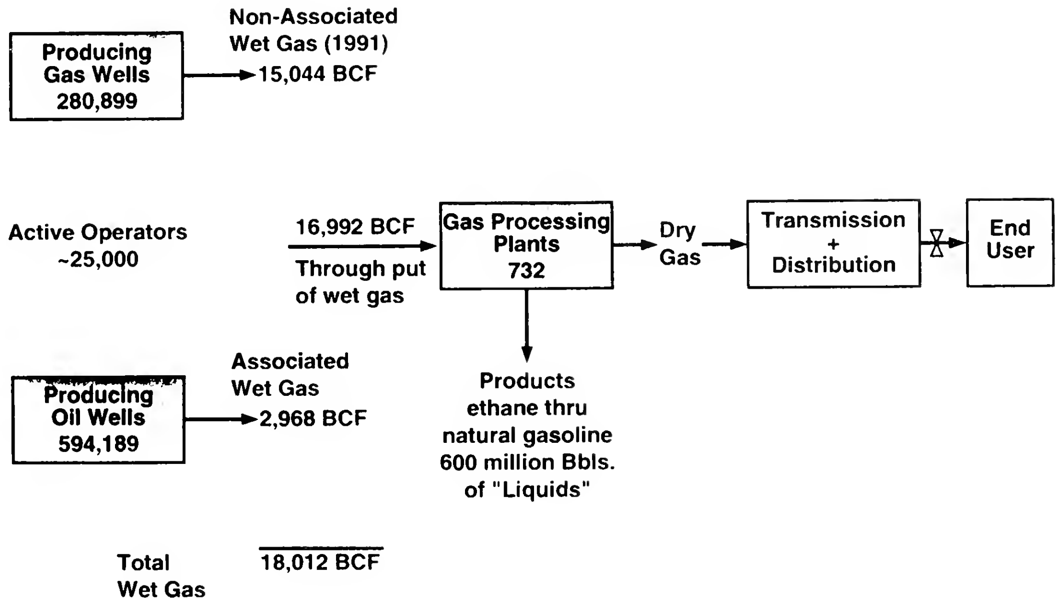
Mr. Chairman, we urge you and the members of the committee to ensure that if an energy Btu tax is enacted, it be structured in a manner that is the most practical and least disruptive for all those providing natural gas to consumers.

I would be happy to answer questions. Thank you.

[Attachments to the prepared statement follow:]

Oryx Energy Company

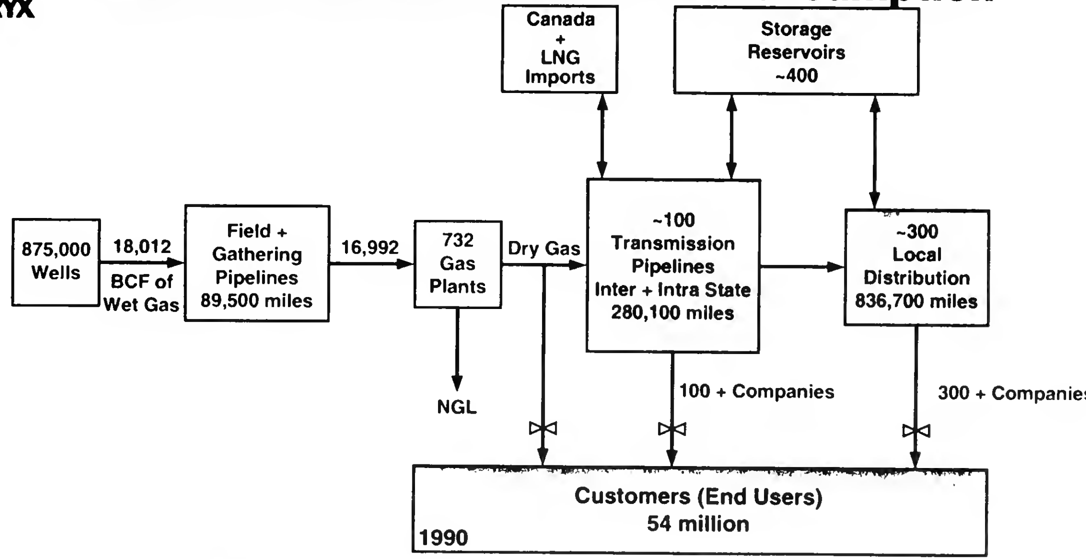
Natural Gas Production and Processing



Oryx Energy Company

ORYX

Natural Gas Distribution and Consumption



Other Gas Use

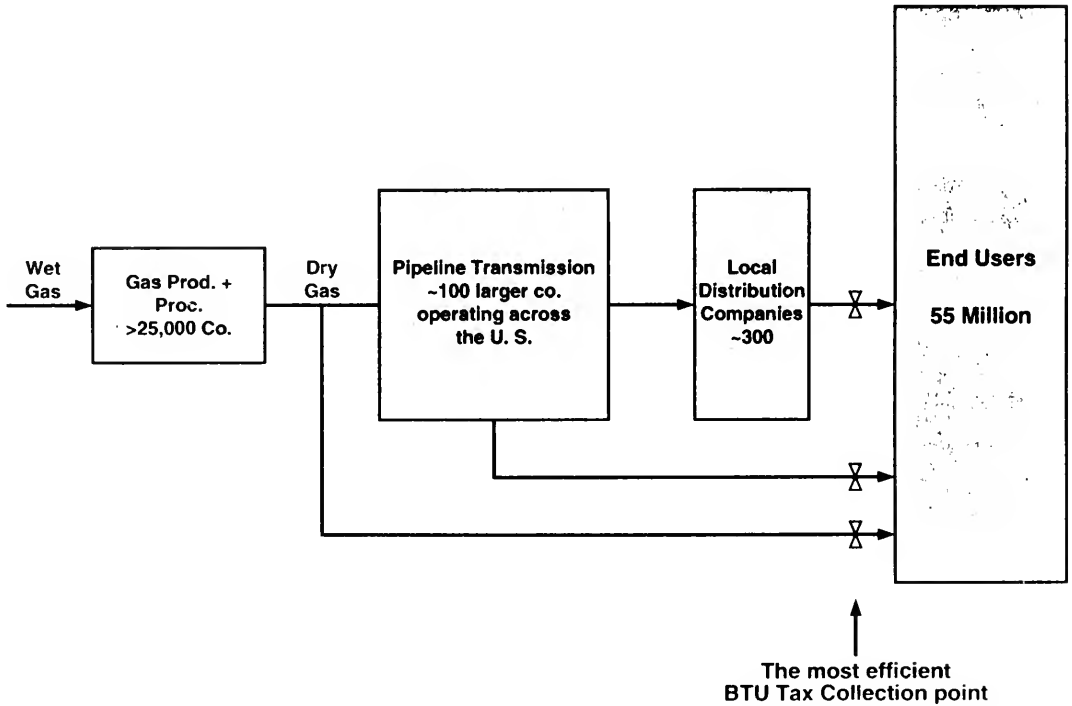
• Field + Plant	1150 BCF
• P/L Compressors	601 BCF
	1751 BCF

	Customers	*1991 Consumption*
Electric Power Generation	400 +	2788 BCF
Industrial	165,600 +	7231
Commercial	4,248,500	2730
Residential	49,830,200	4556
Other	47,900	
Total	54,292,600	17,305 BCF

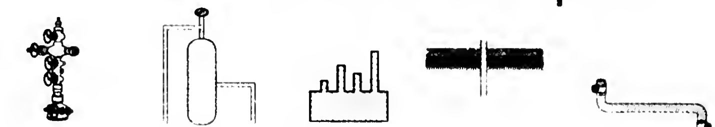
Top 100 Gas Pipelines Handled 43,081 BCF in 1991 (Top 10 handle 50% of Total)
Top 300 Gas Pipelines Handled 13,470 BCF in 1991 (Top 20 handle 32% of Total)

Oryx Energy Company

Transmission, Distribution and Consumption



Natural Gas Flow
Well to Final Consumption



Process	Production *	Treatment *	Processing *	Storage *	Distribution *	Consumption
Equipment	Reservoirs Oil Wells Gas Wells	Separators Dehydrators Amine Units	Plants (NGL Extraction)	Reservoirs Wells	Pipelines	Burners
Players	Royalty Owners W. I. Owners Producers	Producers Pipelines Plant Operations	Plant Operators Pipelines Producers	LDC's (Utilities) Pipelines End Users Producers	LDC's (Utilities)	Residential Commercial Industrial
Fuel Use	Compressors Pumps	Compressors Heaters	Compressors Heaters Pumps	Compressors	Compressors	

* Transmission	* Points of Sale
Pipelines Compressors	Producers Industrials Pipelines LDC's Marketers Brokers
Interstate Pipelines Intrastate Pipelines End Users Producers	
Compressors	Multiple Sales Per *

NGSA COMMENTS ON PRESIDENT CLINTON'S ENERGY TAX PROPOSAL

On February 19, 1993, the Clinton Administration publicly disclosed details of its proposed broad based energy tax (Tax). The Tax would be based on the BTU content of certain fuels including oil and natural gas. The Tax would be higher per MMBTU on oil than gas and would phase in over three years beginning in July, 1994, in one-third annual increments. Non-fuel uses of fossil fuels and exported fossil fuels would be exempt from the Tax. The collection point for domestic crude would be at the "refinery" and for domestic gas at the "pipeline".

The NGSA does not support energy taxes. The Association believes that a more constructive approach toward reducing the deficit would be to further reduce federal spending. If a BTU energy tax is imposed, however, the NGSA offers the following comments for consideration by the Administration and Congress.

The focus of NGSA's comments is on structuring the Tax on natural gas in a manner that is the most practical and least disruptive for all segments of the natural gas industry. It is believed that such an approach would best achieve the federal government's net revenue, conservation and environmental objectives.

The primary issues for both taxpayers and the government revolve around the related concepts of (1) who is the taxpayer, (2) where is the point of taxation, and (3) who serves as the collection agent for the government. The effort to resolve these issues must take into account a host of sub-issues such as (1) minimizing the administrative burdens on both taxpayers and the government, (2) ensuring that domestic natural gas suppliers, marketers and transporters can fairly compete with their foreign competitors, and (3) preventing conflicts with other important government policies.

Based on these considerations, and for reasons specified below, the only practical approach to structuring the Tax on natural gas is by imposing it on the end user of the fuel (taxpayer), at the burner tip (point of taxation), with collection by the last seller (i.e., the local distribution company (LDC), pipeline or other supplier). In general, NGSA believes that fuel used to produce taxable fuel should be exempt from such taxes.

ADMINISTRATIVE BURDENS

- Administrative costs are minimized by imposing the Tax at the burner tip with the last seller as collection agent.
    - Minimizes government audit costs by restricting the size of the audit universe that otherwise expands substantially in the case of upstream tax/collection points due to large number of producers and complexities surrounding exempt non-taxable gas, measurement and other factors.

- Consumer billing system is already in place for residential customers by LDCs and for others due to existing commercial billing practices.

- Avoids the administrative complexities of an upstream tax, e.g., (1) solving nonfuel use exemption issues, (2) avoiding unintended additional tax burdens (occasioned by increased production, gross receipts and other state and local taxes) and royalty burdens under certain lease provisions, (3) solving timing problems associated with gas storage and gas imbalances, and (4) avoiding the costs of pipeline/LDC rate and tariff hearings.

IMPORTATION OF NATURAL GAS

- U.S. natural gas suppliers compete head to head in key U.S. markets with Canadian natural gas suppliers.

  - A burner tip Tax eliminates distortions between domestically produced and foreign imported natural gas which otherwise will arise if the points and time of taxation are not the same for both fuels.

  - If a use tax is imposed on domestic gas used in the transportation and processing phases, but not imposed in a similar fashion on imported gas, distortions will arise. The consequence will be to competitively favor foreign gas which conflicts with the Administration's goals of creating more jobs for U.S. workers and reducing imports for balance of payments and other purposes.

  - Imposing a higher tax rate on imported gas to correct these domestic/foreign imbedded cost distortions raises GATT issues. Further complications arise with regard to gas produced in the Western U.S. that is transported on Canadian pipelines to reach East Coast markets. Without an import credit equal to the Tax, domestic gas will again be disadvantaged.

PREVENTING CONFLICT WITH OTHER GOVERNMENT POLICIES

- The Administration has stressed its support of the use of clean burning fuels such as natural gas. The stability and availability of natural gas supplies is not possible without a strong natural gas industry. Imposition of the Tax in a manner that disrupts the gas industry (which is already undergoing enormous change such as the restructuring of the natural gas transportation industry) would clearly conflict with the Administration's policy favoring increased use of natural gas.

  - Fixed price contracts, which serve government policies and consumers by providing long-term gas supplies at stable prices, would be adversely affected by imposing the Tax on suppliers.

Suppliers locked into such contracts cannot increase prices to reflect the Tax burden.

- The ability of natural gas industry to meet government objectives, such as the development of market centers, will be adversely affected unless the Tax is imposed at the burner tip.

- The ability of the natural gas industry to satisfy consumer demands for a growing array of services, such as gas aggregation, storage and efficient transportation, will be adversely affected unless the Tax is imposed at the burner tip.

IMPOSITION OF THE TAX ON NATURAL GAS LIQUIDS (NGLs)

The Clinton Administration has not yet indicated how to impose or collect the Tax on NGLs.

- NGLs are generally extracted from a natural gas stream in processing at gas plants and then (1) sold to refiners or petrochemical companies either as part of a crude oil stream, or for blending in refined products or as petrochemical feedstocks, or (2) sold to nonrefiners primarily for use as fuel.

- It cannot generally be determined by the gas plant operator which NGLs are sold for use as fuels and which are sold for nonfuel uses.

- If NGLs are taxed by taxing the stream prior to separating out the NGLs or at the gas plant tailgate a complicated exemption certificate or rebate/refund mechanism must be devised to (1) exempt nonfuel uses of NGLs and (2) avoid double taxing NGLs used by refiners in making other taxable fuels, e.g., gasoline.

- NGLs sold for use as fuel (other than to a refiner) should be taxed at the burner tip and collected by the seller from the end user. For reasons discussed with respect to natural gas, this is the only structure that effectively avoids administrative burdens, and unfair competition from imports and promotes government policy favoring natural gas use.

- NGLs generally should be taxed at the same point as natural gas if treated as natural gas.

OTHER ISSUES

While the point of imposition of the Tax (and the closely related question of who is the taxpayer) is the primary concern of NGSA, an exemption for fuel use to create other taxable fuel is necessary to ameliorate some of the burden the Tax itself imposes on the energy industry. The energy industry is being singled out for imposition of a new federal tax on its primary products. This burden, in the form of reduced product demand and increased administrative costs is not shared by any other industry group. Accordingly, while it is true that the energy consumption costs of all industries (not just the energy industry) will increase as a result of the Tax, granting an exemption for that portion of the energy industry's consumption costs directly related to providing taxable fuels to the market is reasonable given that the Tax burden itself is imposed solely on that industry's products.

Mr. PAYNE [presiding]. Thank you, Mr. Hauptfuhrer.
Ms. Roy.

STATEMENT OF ELLEN S. ROY, CHAIR, ENERGY TAX TASK FORCE, NATIONAL INDEPENDENT ENERGY PRODUCERS, AND VICE PRESIDENT, BUSINESS DEVELOPMENT, INTERCONTINENTAL ENERGY CORP., BOSTON, MA

Ms. ROY. Good afternoon. My name is Ellen Roy. I am vice president, business development, of Intercontinental Energy Corp., and the chairperson of the Energy Tax Task Force of the National Independent Energy Producers. I thank you for allowing us to testify on this very important issue.

I am here today to talk about three things. One is to tell you a little bit about the independent power industry and what we do. The second is to explain how the energy tax harms our industry given its current upstream collection point. And the third is to suggest alternatives that would preserve our industry.

Intercontinental Energy Corp. is an independent power producer, or IPP as we say for short, with cogeneration facilities in New Jersey, Massachusetts, and Pennsylvania. The National Independent Energy Producers, or NIEP, as we also say for short, is an association of companies, like ours, that generate electricity for sale to utilities and steam for sale to industry.

NIEP members use highly reliable fossil fuels and renewable technologies, including hydro, pumped storage, geothermal, biomass, wood, waste to energy, as well as natural gas, oil, and coal.

Our companies typically sell power wholesale to electric utilities on the basis of long-term contracts. Since 1989, the independent power industry has supplied over 50 percent of all new electric capacity in the United States.

The key to a fair and efficient energy tax is its collection point. In the administration's February proposal for upstream collection of the tax, the seller of gas, coal, or oil would collect the tax at the point of sale before the fuel is used to produce electricity.

NIEP is concerned that a tax in this form will have the unintended consequence of damaging the independent power industry. IPPs are not like regulated utilities which can, in most cases, pass costs on to ratepayers. Instead, IPPs sell electricity to utilities under long term, firm contracts that do not permit the seller to pass through an energy tax.

The unintended consequence is this: IPPs may have to absorb 100 percent of the tax. And if they absorb the tax in its entirety with no ability to pass it along, the tax could well jeopardize our ability to repay our bank loans or even to keep operating.

To meet the administration's goals, NIEP recommends the following alternative to an upstream energy tax. The energy tax should be imposed downstream at the burner tip for natural gas or at the retail electric meter. This collection point would eliminate the passthrough problems for utilities and IPPs alike.

If a retail tax is not acceptable, the tax should be imposed on the utility which purchases power from an IPP and collected at the point where the IPP-generated electricity goes into the grid.

The tax would be based on the Btu content and the tax rate of the fuel used to produce the electricity sold by the IPP to the util-

ity. NIEP believes this approach to the energy tax better serves the national policy objectives.

For example, the NIEP proposal meets the revenues goals of the administration. We are not asking for an exemption but rather a change on where the tax is imposed.

With respect to conservation, the NIEP proposal aims to levy the tax at the point where the level of fuel consumption is decided. A tax on IPP's will not reduce fuel consumption because IPPs are by contract obligated to deliver power. In turn, utilities have an obligation to serve their ratepayers and therefore must meet retail demand for power.

For this reason, utilities and IPP's both should be assured of the right to pass taxes through to the retail customer who controls demand.

And finally, regarding the goal of administrative ease, NIEP's proposal that utilities collect the tax at the retail meter or pass it through places the tax administration burden on sophisticated tax collectors accustomed to playing this role for State and local governments.

In summary, the proposed downstream tax collection point will result in a more efficient and fair tax. It ensures that fossil fuels used to produce electricity will be taxed, does not jeopardize the economic survival of the IPP industry, and it reduces the number of taxpayers and gives the responsibility for tax collection to the most sophisticated member of the industry.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ELLEN S. ROY
National Independent Energy Producers

I. THE NATIONAL INDEPENDENT ENERGY PRODUCERS

The National Independent Energy Producers ("NIEP") is pleased to submit this testimony on proposals for a broad-based energy tax as part of the President's deficit reduction package. NIEP is an association of companies that generate electricity for sale to utilities and develop cogeneration projects for a variety of users. NIEP membership is comprised of both publicly-traded and privately-held corporations which represent a broad spectrum of fossil fuel-fired and renewable technologies, including hydro, biomass, pumped storage, geothermal, wood and waste-to-energy plants, as well as oil, gas and coal-fired generation and wholesale generation facilities. Our members sell power at wholesale to utilities on the basis of long-term contracts. We do not have captive ratepayers and do not build rate-based, cost-of-service, powerplants.

NIEP is committed to increasing competition in electric power generation markets. Independent energy has grown out of the entrepreneurial and competitive climate fostered by the Public Utility Regulatory Policies Act of 1978 (PURPA). This competition brings efficiently priced power to the nation's consumers.

Since this 1978 legislation opened the door for competitive power, independent electric producers have expanded non-utility capacity to more than 43,000 megawatts of capacity -- equivalent to over 40 large power plants. In addition, this new industry has supplied over 50 percent of all new electric capacity since 1989. This industry relies on state-of-the-art, highly fuel efficient and clean power production technologies. To date, more than $40 billion has been invested in the independent power industry, producing approximately $10 billion in power sales revenue annually.

II. THE IMPACT OF THE PROPOSED ENERGY TAX ON INDEPENDENT ELECTRICITY PRODUCERS

Independent power producers are concerned that the energy tax, as originally proposed by the Administration in February, may unfairly disadvantage the cleanest, most efficient, and most competitive sector of the electric generating industry. Unlike regulated electric utilities which can, in most cases, pass costs on to captive ratepayers, many electric generators, such as independent power producers and utilities who engage in long-term firm wholesale electricity sales, do so under contracts that do not permit the seller to pass through increases in taxes to the ultimate consumer. Under the Administration's proposed upstream energy tax, these contract suppliers may have to absorb the tax, jeopardizing their financing and the economic viability of their plants. Equally important is the effect which this tax design would have on competition in electric power markets. Wholesale generators of electricity, such as independent power producers, compete with traditional cost-of-service plants for the right to build new electric capacity. If independent power producers with long-term contracts are placed at a disadvantage relative to their utility competitors by virtue of the independents' inability to pass through the tax to the ultimate consumer, competition will be tilted in favor of utilities. Consumers may then be denied some of the benefits of competition in electric power markets.[1]

The contracts between wholesale electric generators and their utility customers often have terms of 20 years or longer and cover both fixed costs (capacity payments) and variable costs (energy and operations and maintenance). A 1992 survey by NIEP of existing power sales agreements between independent generators and utilities found that none of these contracts contained provisions permitting the independent generator to pass through to the utility increased costs due to changes in law, including taxes.[2] The ability of a wholesale electric supplier to pass through a fuel tax depends on the nature of the contract energy payment

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1. In enacting the electricity provisions of the National Energy Policy Act of 1992, Congress strongly endorsed the benefits of competition in electric power markets by removing barriers to entry caused by the Public Utility Holding Company Act and opening access for wholesale suppliers to electric transmission facilities.

2. By contrast, electric utilities are entitled to recover from their ratepayers all prudent costs related to changes in law or regulation. In many states, utilities have automatic fuel adjustment clauses which allow price increases attributed to taxes to be passed through and, in the remaining states, can routinely seek regulatory approval for reimbursement from their ratepayers.

provision.[3] In cases where the energy payment is based on fuel market indices which may be affected by the tax, some limited pass through may occur, but full recovery of taxes paid is unlikely.

III. NIEP'S PROPOSAL FOR A FAIR AND EFFICIENT ENERGY TAX

NIEP believes the key to developing a fair energy tax is its collection point, the place in the stream of commerce the tax is imposed. In the Administration's February proposal, the tax is to be collected upstream at the minemouth for coal, the entry into the refinery for oil, the pipeline for natural gas, the production facility for alcohol fuels, point of importation for imported power and petroleum products, and the utility for hydro and nuclear-generated electricity. Under this design, the seller of gas, coal, oil and other non-exempt fuels would collect the tax from the wholesale generators at the point of sale before the fuel is used to produce electricity. As noted above, NIEP believes that a tax in this form will have the unintended consequences of damaging the economic viability and competitive position of the independent power industry.

NIEP recommends that the tax be imposed downstream at the burner tip (retail consumption point for natural gas) or retail electric meter. This collection point would eliminate pass-through problems for utilities and wholesale generators alike.

Alternatively, the tax should be imposed on the utility purchasing electricity at wholesale either at the busbar (where electricity goes from the generation station to the grid, after the point of sale to the utility) or the substation (where the high voltage transmission lines deliver energy which is stepped down to distribution voltages for retail sale). The tax would be based on the Btu content of the fuel mix in the utility purchase.

NIEP believes that this downstream collection proposal better serves the stated objectives of the Administration in proposing the tax. The following objectives have been cited by Administration officials as guiding the design of the energy tax:

1. The tax must increase revenues by $71.4 billion over the 1994-1998 period, or about $22 billion per year by 1998.

2. The tax should have a reasonably balanced impact on different regions of the country.

3. The tax should be easy to administer.

4. The tax should reduce dependence on foreign sources of energy.

5. The tax should reduce environmental damage and promote energy conservation.

NIEP suggests that the design of the tax should reflect three additional principles:

1. The tax should keep interference with energy markets to a minimum;

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3. Energy payments may be:

- fixed over the term of the contract based on administrative determination of long range avoided costs (no pass-through permitted);

- adjusted from a base to reflect a general economic index, such as inflation (partial pass-through only to the limited extent that a tax related rise in fuel costs affects the Consumer Price Index, a general measure of inflation);

- adjusted from a base to reflect energy market conditions and/or purchasing utility's cost of fuel (pass-through occurs to the extent that fuel indices and utility's own cost of fuel reflect tax; it is unlikely that wholesale generators would recover one hundred percent of taxes paid); and

- in certain contracts, such as California Standard offer contracts, indexed to reflect market conditions by a mechanism established by state regulatory commission rule or policy (pass-through contingent on obtaining commission approval for recovery of tax related costs; even if approval given, major delay may be involved).

2. The tax should not create winners and losers within the electricity industry; and

3. The tax should not create disincentives for energy efficiency.

IV. NIEP's PROPOSAL COMPORTS WITH THE GOALS OF THE ENERGY TAX

NIEP's proposal for a downstream collection point either at the burner tip/retail meter or busbar/substation would better serve these objectives than the Administration's upstream proposal:

A. Ease of Administration

There are approximately 3000 electric utilities with retail distribution franchises in the United States. Most of these regulated utilities already collect taxes for state and local governments. They are also accustomed to being regulated on a cost accounting basis. The most efficient way to collect the tax is to have it imposed on the retail ratepayer at his electric meter and collected by the utility. If instead, the tax is be to imposed on the purchasing utility at the busbar or substation, steps should be taken to insure that utilities can pass the tax through to ratepayers. Utility fuel adjustment clauses allow regulated utilities, but not independents and other wholesale generators, to pass Btu taxes through to ratepayers. Because of their obligation to serve, regulated utilities are entitled, under state law, to recover from their customers all prudently incurred costs, including taxes. All but six states have fuel adjustment clauses. These clauses, introduced in the 1970s during the period of highly volatile fuel prices, allow utilities to quickly adjust rates to assure fuel cost recovery rather than wait for a periodic rate proceeding. However, many of the fuel adjustment clauses have caps on the amount of adjustment permitted annually. Some utilities may, therefore, not be able to recover all tax payments unless normalization rules or other measures are adopted by the Congress to assure full pass-through. We endorse efforts to assure that utilities can recover the tax from their ratepayers.

B. Conservation

If one goal of the tax is to create incentives to conserve energy, the entity which pays the tax should also be the one that controls the consumption of fuel. A tax imposed on wholesale generators will not reduce consumption because they are required by contract to deliver power on demand from their utility purchasers. It is the purchasing utility which determines which generating unit on their system will be dispatched. The utility also has an obligation to serve its ratepayers by meeting their demand for electricity. A retail tax or a tax on the utility with assured pass-through to retail customers is more likely to change retail consumption patterns to promote energy conservation.

Policymakers are usually strongly opposed to placing any tax at the retail level for several reasons:

- Visibility. Consumers will be upset if a new tax item is added to their electricity bill; and,
- Ease of administration, both the ability to enforce collection and the desire to minimize the number of people paying the tax. Although, utilities generally are efficient tax and bill collectors.

However, the energy tax is hardly the stealth bomber of the President's comprehensive deficit reduction plan. Moreover, utilities generally do not, or need not, break-out specific cost items, including taxes, on retail customer bills. In announcing the tax, President Clinton called on all sectors of society to sacrifice. In addition, Secretary Bentsen has been explicit in his public statements about the consumer impact of the energy tax.

C. Minimize Interference in Markets

The downstream collection point for the tax on electricity fuels would minimize disruption of competition by avoiding the creation of winners and losers in the electric generation market. Since wholesale generators and traditional cost-of-service facilities will be treated the same with regard to pass-through of the tax, the tax will not interfere with

competition between independent power producers and traditional utilities over the right to build new facilities.

D. Revenue Impact

We note that the downstream collection point may result in a loss of projected revenues from the tax because of losses of energy as collection moves down the stream of commerce. We recognize that it may be necessary to adjust the Btu tax rate to make up significant losses in revenue, consistent with the goal of deficit reduction.

V. OTHER PASS-THROUGH OPTIONS

Several other options for dealing with the pass-through problem have been considered:

- "Grandfather" existing contracts of wholesale producers with terms greater than one year by exempting fuel used in such facilities from the tax. While this proposal would prevent financial hardship to existing facilities and likely have minimal revenue impacts, it may give new utility cost-of-service plants with automatic tax pass-through a competitive advantage over contract suppliers who compete with them for the right to build new capacity but must bargain for the right to pass-through fuel taxes.

- Give wholesale generators a tax credit or rebate for taxes paid on fuel. This proposal exempts such fuel from tax all together, is expensive to administer, and sets a bad precedent for other industries which could "snowball" into substantial revenue impacts.

- Defer collection of the tax on fuel used for generation of electricity subject to long-term contracts -- have the tax collected by the purchasing utility at the busbar or substation. If the decision is made to have an upstream imposition of the tax, this is NIEP's preferred solution to the pass-through problem. It has the disadvantage of somewhat cumbersome tax deferral certificates or rebates. It also does not deal with the problem of fuel lost, in transportation or otherwise, between the point of imposition and point of combustion, or losses of electricity resulting from transmission from the generating plant to the substation.

VI. WHY PASS-THROUGH FOR FUTURE PROJECTS IS IMPORTANT

Pass-through of energy taxes for future as well as existing IPP projects is important to the future of the independent power industry. At first glance, this may not appear necessary. Unlike existing facilities locked into long term contracts, developers of future projects may negotiate new contracts which theoretically could take the possibility of future tax increases into account. In short, it would appear that IPPs should be able to negotiate an agreement with utility buyers to include the cost of the fuel tax in the contractual payments. However, that is not always the case, and the inability to pass the tax through for new contracts could undermine competition in electric power markets.

Because fuel costs are 80-90 percent of a fossil fuel-fired cogeneration facility's variable costs, IPPs may have difficulty financing their plants if they must bear the risk of future tax increases on fuel. This will be especially true in the future if the precedent for energy taxes is established in 1993. At the same time, contractual mechanisms to recover the tax may not be available. Utilities which purchase electricity from IPPs may be very reluctant to assume the tax risks through some form of contract pass-through provision without assurance in advance that their regulatory commissions will allow them to recover the costs of tax payments. State regulators, on the other hand, have typically resisted any advance approval of contract terms which bind future commissions.

This uncertainty may create an artificial incentive for utilities to build rather than buy new capacity, thereby undermining the competitive market for wholesale power. If a utility builds its own facility on a cost-of-service basis, it has a high probability of being able to pass energy taxes through to ratepayers along with other "prudently incurred" costs either through a fuel adjustment clause or in a rate proceeding. Of course it is possible that state regulatory

commissions will insist that fuel taxes be treated the same, whether incurred by IPPs or utilities, but there is no guarantee that will happen.

For this reason, one cannot simply say that the tax risk is just another negotiating point and that utilities will agree to pass-through if they get enough in return for carrying this risk. This would be true in a perfectly competitive market but that is not real world for IPPs. Even in states with commission-sanctioned competitive bidding, electric utilities compete with IPPs for the right to build new capacity. If the ability to pass-through taxes is greater for electric utilities than for IPPs, competition may be tilted against IPPs in favor of the cost-of-service facilities.

The best solution for this problem is either to have the tax imposed on electricity fuels at the retail level or to include in the tax legislation a federal mandate that utilities be allowed to pass through such taxes in their fuel adjustment clauses or other cost recovery mechanism. In any case, it makes sense for the IPP pass-through provision now being considered by the Treasury to apply to future as well as existing facilities.

Allowing the tax pass-through provision to apply to future as well as existing facilities does not add to IRS's administrative burden. Utilities could continue to collect the tax at the recommended collection point in the future under the system already established for existing facilities.

Finally, we should point out that there is precedent in the Clean Air Act Amendments of 1990 for giving IPPs prospective as well as retrospective relief in order to ensure fair competition between utilities and IPPs. In the original acid rain proposal submitted to Congress, IPPs were not allocated sulfur dioxide (SO_2) emission allowances, but were required to hold allowances equal to their emissions. By contrast, utilities were allocated sufficient emission allowances to comply with new standards. Congress recognized that this created an inequity which would harm the emerging competitive electricity markets. To ensure retrospective relief, Congress "grandfathered" existing IPP contracts. In addition, to put new IPPs and new utility plants on a equal footing, Congress created sources of allowances for IPPs to enable them to compete fairly with utilities.

VII. TREATMENT OF FUEL USED TO GENERATE STEAM

Cogeneration facilities produce energy in the form of electricity and steam. Since passage of the Public Utility Regulatory Policies Act of 1978 (PURPA), Congress has favored cogeneration as a means of capturing waste heat from combustion of fossil fuels, converting it to steam, and using it to provide heating and cooling to adjoining industrial customer and/or to generate additional electricity through steam turbines. The thermal efficiency of such facilities is much greater than would be the case if the waste heat from the production of either steam or electricity were simply vented into the air. As Vice President Gore noted in *Earth in the Balance*, "Laws encouraging and even requiring the efficient use of cogeneration technology have an important role to play in reducing the consumption of fossil fuels." (p. 329).

The impact of the proposed energy tax on steam sales by cogeneration facilities was not specifically addressed in the Treasury proposal of February 17th. However, we believe that not only should the tax be neutral with respect to the economic incentives to cogenerate, but in keeping with the Administration's policy goals in designing the tax, encourage cogeneration.

The Treasury proposal would tax the Btu content of fossil fuels, not electricity or steam per se. If IPPs, as purchasers of fuel, cannot pass through the taxes levied on these fuels upstream to the buyers of their electricity and steam, the financial viability of some projects may be impaired. In cogeneration facilities where steam is produced only to the extent necessary to qualify under PURPA, the lack of ability to pass tax related fuel costs through to the steam purchaser may not pose a problem if the IPP can pass through such costs to its electricity purchaser. On the other hand, if the steam produced by the cogenerator exceeds the minimum waste heat threshold, the utility purchaser of the IPP's electricity would not be willing to pay taxes on fuel used to produce steam rather than electricity.

With respect to the tax treatment of the fuel used to generate steam in a cogeneration facility, we propose the following:

- In keeping with existing federal incentives for energy efficient cogeneration, the fuel attributed to steam output for a qualified cogeneration facility should not be taxed. If that alternative is unacceptable, at a minimum, the tax should apply only to fuel used to produce steam above the PURPA-minimum five percent of total energy output.

- For purpose of measurement and allocation of the tax between fuel used to produce steam and electricity in a qualifying cogeneration facility, the tax should be calculated assuming a one-hundred percent conversion efficiency for steam. Therefore, under our proposal, the total Btu value of the steam produced would be subtracted from the total Btu of fuel consumed at the facility. The electricity purchaser would pay the tax based on the remaining Btus.

VIII. EXEMPTIONS FOR NON-CONVENTIONAL FUELS

The Administration proposes to exclude certain "non-conventional" fuels from the Btu tax, including solar, geothermal, biomass, wind or other fuels. It has been suggested that certain other fuels should be considered "non-conventional" fuels, including waste fossil fuels used for the generation of electricity, such as waste coal and petroleum coke. While NIEP takes no position on tax exemption for individual fuels, the following data may be helpful.

A. Exemptions for Waste Fuels

In its regulation of qualifying facilities under PURPA, the Federal Energy Regulatory Commission ("FERC") defines waste as "an energy source that has essentially no commercial value." Because the Btu content of waste coal is low compared to gas, oil and even conventional coal, a greater volume of it is required to produce a kwh of electricity. A Btu tax, when imposed on a low Btu, low value fuel, has a disproportionate impact on the price of electricity produced from such fuel. This raises the question whether taxing such sources at the same rate as conventional coal or oil puts an unfair burden on the user.

By including waste fuels in the definition of qualifying small power production facilities under PURPA, Congress sought to encourage the use of these resources for many of the same public policy reasons that the Administration proposed to exempt "non-conventional" fuels -- that is, promoting energy efficiency, reducing dependence on foreign energy sources and improving the environment. In 1990, Congress reinforced its preference for such fuels by removing size limits on these technologies originally imposed by PURPA.

For example, recent developments in technology over the past few decades have made it possible to use waste coal as a fuel to generate electricity and steam. About three billion tons of waste coal sit on land adjacent to current and former coal mines. These piles, many of which have been abandoned for decades, pose environmental hazards because they leach acid into groundwater, blow dust into the air, catch on fire or slide down into roads. Despite these hazards, the companies which own them and are still in business cannot afford to clean up these areas. Rather than eventually forcing a state or local government to foot the bill for clean-up, waste coal can be used as a fuel for electricity and steam generation.

Other waste technologies, such petroleum coke, a by-product of petroleum refining, when used as generating fuels, may provide additional economic benefits to a region and result in the more efficient use of domestic oil. Also, these combustion technologies must meet the strictest new source standards for their emissions.

The decision whether to provide an exemption of waste fuels from the proposed Btu tax or other relief for low Btu waste fuels will depend on an assessment of the net societal environmental and economic benefits from using waste coal or petroleum coke to generate electricity.

B. Elimination of Double Taxation of Energy Storage Technologies

Energy storage technologies, such as hydroelectric pumped storage and compressed air energy storage, represent a unique resource by consuming low-value surplus power during periods of low demand to store energy for use during periods of high demand. More than 20,000 MWs of energy storage are now in various stages of planning and development by independent power producers, utilities and public agencies. Under the current Administration proposal, electricity generated from energy storage would be subject to a direct double-level tax.

A tax would be imposed on the fuel used to generate the electricity used to store energy. An additional tax would be imposed on the hydropower used to generate electricity from the energy storage facility.

Energy storage facilities compete directly to produce peaking power with technologies such as gas turbines. In the case of gas turbines, the natural gas burned to generate electricity would be taxed, but not the electricity produced. To double tax energy storage would place it at a competitive disadvantage relative to other peaking resources. In addition, in some cases, the tax could disadvantage independent energy storage facilities relative to utility-owned facilities.

Therefore, we believe it would be appropriate to exclude the electricity generated from energy storage facilities from the Btu tax. The tax would continue to be imposed on the fuel used to produce the electricity used for storage.

IX. CONCLUSION

The proposed downstream tax collection point best serves the Administration's stated objectives for the energy tax. It ensures that all fossil fuels used to produce electricity will be taxed. It does not give cost-of-service facilities with pass-through capability a competitive advantage over contract suppliers. It reduces the number of taxpayers and gives the responsibility for tax collection to the most sophisticated entity in the electricity stream of commerce. And further, it advances energy conservation by ensuring that those entities with the discretion to control energy consumption -- utilities which control dispatch of contract generators and ratepayers who control demand for power -- either collect or pay the tax.

Mr. PAYNE. Thank you very much.
Mr. Sabourin.

STATEMENT OF DENNIS M. SABOURIN, VICE PRESIDENT, POSTCONSUMER PROCUREMENT AND RECYCLING INDUSTRY AFFAIRS, WELLMAN, INC., SHREWSBURY, NJ, AND CHAIRMAN OF THE BOARD, ASSOCIATION OF POSTCONSUMER PLASTICS RECYCLERS

Mr. SABOURIN. Good afternoon, Mr. Chairman. I would like to thank you for the opportunity to be with you today.

I am a corporate vice president with Wellman, Inc., and I am also a chairman of the board of the Association of Postconsumer Plastics Recyclers, which is an industry organization formed in 1992.

My purpose in speaking with you this afternoon is to offer Wellman's thoughts about the President's economic plan and specifically on the advantage of and necessity for investment tax credits for the recycling industry.

Additionally, I would like to comment on energy taxes and how energy taxes affect those experiencing off-shore competitive threats.

Wellman is a Fortune 500 company with sales in excess of $820 million in 1992. We employ about 3,500 people both in the United States and Europe, and we are the largest recycler of PET soda bottles in the United States. In fact, in 1991 Wellman recycled more than 1.5 billion soda bottles and this material was utilized to make textile, fiber, and extruded sheet film which is used in a number of consumer products.

An investment tax credit for green companies that would divert recyclable materials from expensive and disappearing landfills is necessary and needed in order to expand the recycling industry.

This expansion will do three important things for the U.S. economy: First, conserve energy and natural resources; second, develop much needed solid waste and recycling infrastructure; and third, create jobs.

As chairman of the Association of Postconsumer Plastic Recyclers, I am able to interface with a wide range of entrepreneurs and entrepreneurial businesses involved with the recycling of postconsumer plastics. The APR is made up of 66 members, all of whom have dedicated assets in the recycling of postconsumer plastics. This industry is faced with difficult and challenging competitive factors.

An investment tax credit for the reclamation industry would promote the expenditure of necessary funds to purchase sorting and reclamation equipment and make this industry more price competitive.

Waste management programs have traditionally been locally and State managed. Because of limited municipal budgets, ownership of MRF's, Municipal Recycling Facilities, have been transitioning from publicly financed to privately financed enterprises. An investment tax credit for green companies would give a boost to private-sector ownership and development of a solid waste management infrastructure.

An important element of the recycling infrastructure industry is job creation. MRF's, municipal recycling facilities, are normally

built in high population areas where there is a preponderance of municipal solid waste. It is in those same areas that there is usually an acute job shortage.

The unskilled laborers that are used in MRFs, who work in a safe, clean environment, are often an opportunity for individual rapid upward mobility. Wellman owns MRFs through its CRInc. facility and we have several examples of unskilled labor who we have hired who have transitioned into management positions.

Now, initial reports indicate that the new administration direction for investment tax credits appear to favor small industry. We feel that this concept should be expanded to include green industries as well. This is particularly true where green industries work with municipalities who require guarantees, bonding, and reference plants not available to or possessed by small businesses. The development of green industries which could be affected by fostering an ITC should be allowed for both small industries and large as well.

Wellman understands the need for an energy tax as a deficit reduction measure. We feel, however, that an energy tax placed only on domestic industry would result in an unlevel playing field. We feel that imported materials which compete with domestically manufactured products should carry the same financial burden.

We suggest that an assessment be placed on imported materials that would be equivalent to the energy imposed on domestically manufactured materials. This levy would be considered an environmental tax or environmental levy, if you will, and this assessment could either be used as a deficit reduction measure or could be used to fund programs for world ecological initiatives.

In conclusion, I would like to again thank you for your time and inspiration. We strongly support the implementation of an investment tax credit for green companies as well as an energy tax that would not be discriminatory to domestic manufactured businesss.

[The prepared statement follows:]

TESTIMONY OF DENNIS M. SABOURIN
Association of Postconsumer Plastics Recyclers

Mr. Chairman, Members of the Committee, thank you for the opportunity to discuss the President's economic plan, investment tax credits, and the proposed energy tax. My name is Dennis Sabourin; I am a Corporate Vice President with Wellman, Inc. Wellman is the largest recycler of PET soda bottles in the United States. My specific area of responsibility is the procurement of postconsumer plastic recyclables and recycling industry affairs. I am also Chairman of the Board of the Association of Postconsumer Plastics Recyclers (APR). This organization was formed in 1992. In order to be a member of the APR, a company must have dedicated assets in the reclamation of postconsumer plastic materials.

My purpose in speaking to you this moming is to offer Wellman's thoughts about the President's economic plan, and specifically on the advantage of and necessity for investment tax credits for the recycling industry. Additionally, I will comment on energy taxes and how energy taxes affect those experiencing offshore competitive threats. The plan encompasses the overall theme of increasing public and private investment in order to provide more productive, higher-paying jobs and greater economic opportunities. A plan of this nature which devotes itself to modernizing factories and equipment, developing skills, and accelerating the advancement of technology is imperative in today's environment. The need to increase investment motivates all three elements of the Clinton economic plan: stimulus, investment, and deficit reduction.

Wellman is a Fortune 500 company with sales in excess of $828 million in 1992. Wellman employs more than 3,500 people in the United States and Europe. Wellman's divisions are involved in the manufacture of polyester and nylon fiber both from recycled and chemical-based products, the processing of wool fleece, the manufacture of non-woven polyester products, the manufacture of engineering resins, the manufacture of polyester sheet extruded film which is used in the thermoforming industry, and the CRInc. Division which designs, builds, and operates Material Recovery Facilities (MRFs). Wellman is both a user of industrial recyclables and postconsumer plastic recyclables.

In 1992, Wellman recycled more than 1.5 billion soda bottles. The PET recycled from these bottles was used in the manufacture of fiber products and PET sheet. Wellman markets this high-quality polyester staple fiber under the brand name Fortrel Ecospun. Examples of some of the products manufactured with Wellman fiber are carpeting; fiberfill for pillows, comforters, furniture; fleece fabric for outerwear and sports apparel; geotextile products for highway construction projects and landfill liners; and many other needed products. You know our thermoformed products as the scoop in the laundry detergent box. Every pound of PET bottle that was recycled displaced a pound of virgin chemical material. Wellman wishes to expand its reclamation facility to enable it to recycle more postconsumer plastics.

SUPPORT FOR INVESTMENT TAX CREDIT

The President's plan proposes major additions to ongoing activities that expand America's capacity to produce and provide more opportunities for current and future workers. Its intent is to help shape and expand the nation's infrastructure and the recycling infrastructure must be a key element.

An investment tax credit for "green" companies that would divert recyclable materials from expensive and disappearing landfills is necessary and needed in order to expand the recycling industry. This expansion will do three important things for the U.S. economy. It will 1) conserve energy/natural resources, 2) develop much needed solid waste/recycling infrastructure, and 3) create jobs.

CONSERVE ENERGY/NATURAL RESOURCES

As Wellman recycles more plastic bottles, it will displace more and more virgin chemically-derived materials. We must not lose sight of the fact that energy independence is important to the future of our nation. Reclamation of postconsumer products is an important part of energy conservation and self-sufficiency.

SOLID WASTE/RECYCLING INFRASTRUCTURE DEVELOPMENT

As Chairman of the Association of Postconsumer Plastics Recyclers, I am able to interface with a wide range of entrepreneurs and entrepreneurial businesses involved in the recycling of postconsumer plastics. The APR is made up of 66 members, all of whom have dedicated assets in the recycling of postconsumer plastics. This industry is faced with difficult and challenging competitive factors.

Postconsumer plastics are most usually available in the waste stream in mixed form (i.e., a number of different kinds of plastics being collected at the same time). In order to separate these plastics into their component types and ready them for use as industrial feedstocks, it is necessary to employ expensive sorting technology. An investment tax credit for the reclamation industry would promote the expenditure of the necessary funds to purchase sorting and reclamation equipment and make this industry more price competitive.

Waste management programs have traditionally been locally or state managed. In the past, municipal material recovery facilities (or MRFs) and construction and demolition waste recovery facilities have been publicly owned. Because of limited municipal budgets, ownership of MRF's and construction and demolition waste recovery facilities has been transitioning from publicly financed to privately financed facilities. Local and state governments continue to look to the private sector for expansion of waste management facilities. An ITC for "green" companies would give a boost to private sector ownership and development of the solid waste management infrastructure. Additionally, an investment tax credit for municipal solid waste facilities would encourage the investment in technologically advanced safe work environment.

JOB CREATION

An important element of the recycling infrastructure industry is its job creation. The building of MRFs not only helps to solve the ever-present municipal solid waste problem but it also creates jobs, professional jobs and unskilled labor positions in inner-city, hard-core unemployment areas. As an example, MRFs that have been built by CRInc., a Wellman environmental company, have created more than 300 jobs over the last four years. MRFs are normally built in high population areas where there is a preponderance of municipal solid waste. It is in those same areas that there is usually an acute job shortage. The unskilled laborers used in MRFs work in a safe, clean environment and are offered opportunities for individual rapid upward mobility. There are several examples within the CRInc. organization where individuals were hired as unskilled labor and have transitioned to management positions.

ITC, NOT JUST FOR SMALL BUSINESS

Initial reports on the new administration's direction for investment tax credits appear to favor only small industry. We feel that this concept should be expanded to include "green" industries as well. This is particularly true where "green" industries work with municipalities who require guarantees, bonding, and reference plants not available to or possessed by small businesses. The development of "green" industries, which can be effectively fostered by an ITC, requires large and small businesses alike.

COMMENTS ON ENERGY TAX

Wellman understands the need for an energy tax as a deficit reduction measure. We feel, however, that an energy tax placed only on domestic industry would result in an "unlevel playing field." We feel that imported materials that will compete with domestically manufactured products in the United States should carry the same financial burden. We suggest that an assessment be placed on imported material that would be equivalent to the energy tax imposed on domestically manufactured materials. This levy would be considered an "environmental tax" or an "environmental assessment." This assessment could be used to fund programs for world ecological initiatives. This initiative could either be a stand-alone organization funded by the United States or the funds funneled to one of the existing global environmental organizations.

CONCLUSION

I would again like to thank you for your time and inspiration. We strongly support the implementation of investment tax credits for "green" companies. We feel that this will advance the U.S. economy through energy conservation, solid waste/recycling infrastructure development, and job creation as well as an energy tax that would not be discriminatory to U.S. domestic manufacturing businesses.

Mr. PAYNE. Thank you very much.

Dr. Lashof.

STATEMENT OF DANIEL A. LASHOF, PH.D., SENIOR SCIENTIST, NATURAL RESOURCES DEFENSE COUNCIL

Mr. LASHOF. Thank you very much, Mr. Chairman. My name is Daniel Lashof, and I am a senior scientist with the Natural Resources Defense Council.

NRDC, as well as many other major natural and environmental organizations, strongly supports the Btu energy tax as part of the President's economic package. Collectively, a number of organizations wrote to Chairman Rostenkowski a few weeks ago representing more than 6 million members expressing our support for that tax as part of the package.

I think it is important even as this hearing focuses specifically on the energy tax that we keep the energy tax in the context of the package as a whole. It is only one component of it. It is a very important component, but in assessing the impacts on particular regions, on industry, on consumers, it is essential to look at the package as a whole and not to pick it apart. The President made that very clear in his presentation to the country and I think it is important to remember that point as we discuss the energy tax.

That having been said, we do think that the energy tax as part of the package is very helpful. It makes the package a credible way to address the deficit and restore the economic vitality of this country. And, in fact, only an energy tax designed to do double duty fighting pollution could actually gain the support of at least some constituents in the country.

Nobody likes to pay taxes, but recognizing that we have to do something about the deficit, by selecting a tax that actually has environmental benefits, we actually have at least one community here, members of the environmental community throughout the country who actually support that tax.

And furthermore, the energy tax is the only tax that gives all citizens a perfectly legal way to evade it, which is by investing in insulation, advanced lighting, high-efficiency motors, high-mileage cars and other energy efficiency measures. All taxpayers have an opportunity to actually reduce their energy costs by more than the cost of the energy tax.

And in this case, the more tax evaders we have, the better off the country will be as it becomes more efficient reducing its use of nonrenewable energy sources and the environmental impacts associated with that consumption.

I caution that those benefits that are inherent in the structure of the Btu tax as proposed by the President would be lost if the tax was fundamentally altered. For example, as I know has been discussed by some, if an ad valorem type of energy tax was substituted for the Btu tax or if a VAT tax, which many previous witnesses have supported, were substituted for the Btu tax, those benefits and the support of the environmental community for this tax package would be lost.

I think that it is important to look specifically at these alternatives for example, with the ad valorem energy tax, if that were collected at a consumer level, it would have a very perverse effect.

Whereas the Btu tax encourages efficiency, for example, in the production of electricity, with the ad valorem tax, if you had a very inefficient power plant that was cheap to build but had high fuel costs, that was selling electricity, for example, for 5 cents a kilowatt hour, and a much more efficient plant with higher capital costs but lower fuel costs, they would pay exactly the same ad valorem tax and therefore that incentive would be lost.

Another point I would like to make: There has been a lot of discussion on the competitive impact of imposing this energy tax. I think we should keep this in perspective. Again, looking at the package as a whole, to the extent that long-term interest rates are reduced, then in fact industry will be better off because their cost of capital, including their cost of capital to invest in energy efficiency increases will be reduced. And also this tax is really quite modest in its overall impact.

Attached to my testimony is a table which shows that whether it is through taxes or other factors, all of our major industrial competitors in fact pay less for energy in the industrial sector than we do. Even when the tax is fully phased in in 1996, that will still be the case. So we believe that this energy tax has many benefits and will in fact increase our competitiveness as the deficit is credibly attacked, and not reduce it.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of

Daniel A. Lashof, Ph.D.
Senior Scientist
Natural Resources Defense Council

before the

Committee on Ways and Means
U.S. House of Representatives

March 23, 1993

I. Introduction

Thank you Mr. Chairman and members of the Committee. My name is Daniel A. Lashof, and I am representing the Natural Resources Defense Council (NRDC), where I serve as a Senior Scientist. NRDC is a non-profit environmental protection organization, founded in 1970 and supported by some 170,000 members nationwide. I hold a doctorate in Energy and Resources from the University of California at Berkeley.

Mr. Chairman, three years ago you had the foresight to hold hearings on Environmental Emission Fees and Tax Incentives to Protect the Environment and I had the privilege to represent NRDC at those hearings. NRDC has also testified in support of the tax on ozone depleting chemicals that was passed as part of the Omnibus Budget Reconciliation Act of 1989, and we appreciate the fact that this Committee has strengthened this tax over time as new developments have warranted. I am pleased to return today to discuss President Clinton's economic package, and in particular its BTU energy tax component.

On March 11, 1993 NRDC, along with American Rivers, Friends of the Earth, the National Wildlife Federation, the Sierra Club, and the Union of Concerned Scientists, collectively representing some 6 million members, wrote to you expressing our strong support for the BTU energy tax as part of the economic package proposed by President Clinton. I would like to reiterate that support here today.

II. The President's Economic Package and the BTU Tax

Taken as a whole, the Clinton Administration's economic package is both fair and progressive. It credibly addresses our crippling deficit, while laying the foundation for long-term economic vitality. And it repudiates the false choice between economic growth and environmental protection that has too long served special interests at the expense of the public interest. President Clinton's proposal makes cleaning up our environment and promoting new and cleaner technologies an integral part of fostering economic growth and putting Americans back to work.

Each component of the economic package takes important long-overdue steps in addressing the economic and environmental problems associated with our current energy system. The President has proposed to cut many obsolete and environmentally destructive programs, using some of the savings for deficit reduction and to fund investments in energy efficiency infrastructure and R&D. For example, the package would phase out below-cost timber sales, cut back nuclear reactor R&D, and reduce water subsidies. Meanwhile, the stimulus and investment packages would upgrade urban transit and intercity rail service, increase the energy-efficiency of federal buildings and

low-income housing, and increase R&D on renewable energy and advanced efficiency technologies.

Having concluded that he must increase revenues as well as reduce spending, the President's tax package includes a BTU energy tax that will do "double-duty" fighting pollution as well as the deficit. Implementing the BTU tax would be an important first step toward shifting the tax burden from jobs and investment to pollution and consumption. Unlike other types of taxes, the energy tax not only helps fight the deficit, it rewards investments in energy efficiency and discourages the energy waste that contributes to air pollution and global warming. Coupled with other necessary energy policies, an energy tax is one important component of a comprehensive strategy to reduce our dependence on oil, become more efficient and competitive, and fulfill our international commitments under the United Nations Framework Convention on Climate Change.

III. Benefits of the BTU Tax

Those opposed to energy taxes traditionally argue that they are regressive. President Clinton, on the contrary, has demonstrated how to introduce energy taxes as part of a progressive package. In terms of total revenues, the proposed increases in earned income tax credits, food stamps, and low-income energy assistance (LIHEAP) more than offset the burden of energy taxes on low income households. In addition, programs to weatherize low-income households -- provided they are sufficiently funded and designed to effectively reach all eligible households -- will allow recipients to come out ahead financially, even as the nation benefits environmentally.

In fact, only an energy tax gives all citizens a perfectly legal way to evade it. By investing in insulation, advanced lighting equipment, high-efficiency motors, and high mileage cars, every tax-payer can cut their energy bill by more than the 3-8% direct increase produced by the tax. And in this case, the more "tax evaders" there are, the better off we will be as a nation.

The impact of the President's proposal is also very uniform throughout the country. According to a table prepared by the Department of Energy (Table 1) the incidence of the energy tax as a percentage of income varies from region to region by no more than 11% compared to the national average.

Some have suggested that the energy tax will reduce the international competitiveness of U.S. industry. The opposite is true. Even after the BTU tax is fully phased in (July 1,1996), prices for <u>all types</u> of energy paid by U.S. firms will remain well below corresponding prices paid by their European and Japanese competitors (see Table 2). And U.S. industries, just like consumers, still have plentiful opportunities to reduce their overall energy bills by making their operations more efficient. At the same time, lower long-term interest rates produced by demonstrating a real commitment to reduce the deficit will cut the cost of making these and other capital investments needed to raise productivity.

The President's proposal was carefully crafted and balanced. Environmentalists would frankly have preferred a larger tax and one tied more directly to pollution. We are resisting the urge to suggest such changes, however. Others should do likewise. Any problems that might be avoided by modifying the President's proposal are sure to create new, although perhaps as of yet unappreciated, problems. What may start as tinkering could soon lead to unraveling. This will serve no one's interests. It will simply serve to undermine the nation's ability to address seriously the budget deficit.

I urge the Committee to reject any attempt to alter the President's proposal significantly, such as replacing the BTU tax with an *ad valorem* energy tax or a general consumption tax.

As the President said in his State of the Union address, an *ad valorem* tax would have the perverse effect of exacerbating energy price shocks, which can be expected to recur due to instability in the Middle East. In addition, an *ad valorem* tax, at either the wholesale or retail level, would have significantly smaller environmental benefits than the BTU tax proposed by the President. If imposed at the wholesale level an *ad valorem* tax would have perverse regional effects and would disadvantage natural gas, particularly given projected increases in wellhead prices over the next several years.

At the retail level, an *ad valorem* tax would fall disproportionately on electricity, as it would tax the embedded cost of capital in power plants and transmission lines. This would eliminate any incentive for utilities to become more efficient in generating power. An inefficient power plant with high fuel costs and low capital costs could produce the same tax liability as a highly efficient plant with low fuel costs but higher capital costs. Similarly, the incentives to invest in energy efficiency and cleaner fuels inherent in the BTU tax would be completely lost with a general consumption or value added tax.

IV. Related Environmentally-Important Tax Issues

Before addressing the details of implementing the BTU tax, I would like to touch on four related issues in this Committee's jurisdiction. Some of these issues will be addressed in more detail by Dawn Erlandson from Friends of the Earth when she testifies next week.

- **Gasoline tax extension.** NRDC supports extension of the 2.5 cents per gallon gasoline tax currently scheduled to expire in 1995. If this revenue stream is dedicated to the Transportation Trust Fund, however, it is essential that at least 20% of the revenues (0.5 cents per gallon) be dedicated to transit projects, as has been the case historically.

- **Expand coverage of ozone depleting chemicals tax.** Hydrochlorofluorocarbons (HCFCs) and Methyl Bromide have both recently been added to the list of controlled substances under the Montreal Protocol on Protection of the Stratospheric Ozone Layer. Correspondingly, these chemicals should be subjected to the ozone depleting chemicals tax at a rate that reflects their respective Ozone Depleting Potentials (ODPs).

- **Provide full income tax exemption for energy efficiency rebates.** The Energy Policy Act of 1992 provided a partial exemption for payments received from utility companies as energy efficiency rebates. This exemption should be expanded to 100% for all utility customers.

- **Provide tax incentive for energy efficient mortgages.** The Cranston-Gonzalez Affordable Housing Act of 1990 requires the Secretary of HUD to promulgate a uniform program to allow cost-effective energy efficiency improvements to be included in home mortgages at the time of purchase or refinance. Participation in this program may be minimal, however, unless the Federally Chartered secondary mortgage market companies have an incentive to promote energy efficient mortgages that overcomes their concerns about increased financial exposure in case of default. This could be accomplished by providing tax-free interest earnings on the energy improvement portion of energy-efficient mortgages (up to $5000 per home). This tax incentive would provide enormous leverage to stimulate private investment in home improvements and would allow home owners to make efficiency improvements that more than compensate for the BTU tax.

V. Implementation of the BTU Tax

In addition to our commitment to the basic structure of the BTU tax proposed by the Administration, we are concerned with a number of technical issues regarding its implementation. We believe that two basic principles should guide resolution of these technical issues. First, to encourage energy efficiency throughout the production process, the energy tax should be collected as far upstream as possible and all energy consumed in the U.S. economy should be taxed (excluding only emerging environmentally sound renewable energy sources, such as wind and solar). Second, if it is impossible to collect the tax where a particular fuel is first introduced into the economy, any changes in collection point or coverage should be revenue neutral. Application of these principles to a number of specific proposals is discussed below.

- **Enhanced oil recovery.** There should be no exemption for energy consumed in enhanced oil recovery. The first principle is that all forms of energy consumption should be taxed. Consuming oil to produce oil is in principle no different from consuming natural gas to produce electricity. Taxing both the oil and gas consumed in producing heavy oil at the appropriate rates will also encourage these producers to rely more on gas, improving local air quality in the producing regions.

- **Collection point for petroleum.** The first principle implies that the specified oil tax rate of 59.9 cents/million BTU applies to crude oil. Applying it to refined products would exclude the energy consumed in the refinery from taxation and reduce the incentive to increase refinery efficiency. Refined products imported into the U.S. should be charged a rate adjusted upward by the average refinery energy consumption required to produce that petroleum product. If this approach proves unworkable and the Administration decides to collect the tax at the exit of the refinery, then all products should be charged a rate adjusted upward by the average refinery energy consumption required to produce that petroleum product.

- **Collection point for natural gas.** The collection point should be the wellhead or the beginning of the pipeline to provide an incentive to make pipeline operations more efficient and minimize losses. If the collection point is moved to the downstream end of the pipe, revenue neutrality requires that the rate be adjusted upward to reflect the gas consumed to operate the pipeline.

- **Alcohol fuels.** Alcohol fuels should be taxed at the petroleum rate of 59.9 cents/million BTU. Failure to do so will distort the liquid fuels market. Ethanol is already heavily subsidized ($7.90 per million BTU) and its production through current methods is extremely damaging environmentally. (An exemption could be considered for the emerging technology for producing ethanol from woody biomass [lignocellulose]). A lower tax rate for alcohol fuels could also lead to imports, particularly of methanol, undermining the national security justification for the oil supplement.

- **Treatment of feedstocks.** Specific rebates should be provided only when a fuel is used as a material rather than a source of energy. Downstream rebates based on production should be used rather than upstream exemptions for energy forms that are used for a variety of purposes. The appropriate test is whether the chemical elements in the fuel end up in the final non-fuel product. For example, a manufacturer of polyethylene should be entitled to a rebate to the extent that the hydrogen and carbon from petroleum is incorporated into this product. If this material is later used for energy (e.g. in an incinerator) it should be taxed at the appropriate rate at that time. This is important to provide appropriate incentives for recycling.

- **Coal-seam methane.** Methane extracted from a coal-seam as part of a mining operation should be exempt from the tax. If not captured this methane would be released to the atmosphere, contributing to global warming. Thus, taxing coal seam methane would tend to increase, rather than reduce, pollution.

Hydropower. Hydropower should be taxed at the average BTU content of fossil-fired electricity. This is appropriate because of hydropower's harmful impacts on the environment and the need to ensure regional equity in the tax package. Because no combustion is involved in generating hydroelectricity the BTU number assigned to it is by definition somewhat arbitrary, and must be determined by considerations of policy, not physics. Hydro is a mature technology that has varying environmental impacts depending on site specific circumstances which should be considered through local and regional Integrated Resource Planning. In general, hydropower can not be considered a clean renewable energy source. It has contributed to dramatic declines in fisheries, species diversity, riparian habitat, and river water quality.

TABLE 1

Impact of Energy Tax on Consumers by Region

Census Region	Tax Increase (Full Rates*)		Percent of National Average	
	Amount Per Capita	As a Percent of Income	Amount Per Capita	As a Percent of Income
New England	$103	0.54 %	117 %	99 %
Middle Atlantic	93	0.50	106	93
South Atlantic	89	0.56	102	104
East North Central	87	0.55	99	101
East South Central	80	0.60	91	111
West North Central	88	0.58	100	106
West South Central	83	0.59	94	109
Mountain	82	0.57	94	105
Pacific	86	0.49	98	91

* Rates become fully effective July 1, 1996.

TABLE 2

BTU TAX WOULD NOT HARM U.S. COMPETITIVENESS

The BTU tax proposed as part of the Clinton-Gore economic package would raise U.S. energy prices by 3-8% for consumers, and less than 20% for any energy user, when fully phased in. Even with this tax in place U.S. energy prices for all types of energy would remain well below corresponding prices in Europe and Japan. The table below shows current energy prices in Europe and Japan as a percentage of current U.S. energy prices.

ENERGY PRICES IN OTHER COUNTRIES EXPRESSED AS A PERCENTAGE OF U.S. PRICES (U.S. = 100)

	OECD EUROPE	GERMANY	JAPAN
INDUSTRIAL ENERGY			
Light Fuel Oil	148	148	119
Heavy Fuel Oil	155	130	171
Electricity	158	190	265
Natural Gas	122*	169	372
Steam Coal	241	411	276
HOUSEHOLD ENERGY			
Gasoline	293	258	281
Residential Oil	141	104	111
Electricity	167	207	230
Natural Gas	147*	170	404

Astrict indicates 1989 data. All other data are from 1990.
Source: Energy Prices and Taxes 1992. International Energy Agency.

Mr. PAYNE. Thank you very much, Dr. Lashof.

You mentioned in your testimony that you had concerns about an ad valorem tax collected from the consumer. Does that also apply to a Btu tax that might be collected at the consumption level?

Mr. LASHOF. No, the considerations on the Btu tax collection point are somewhat different. We believe that environmentally it would be best to collect the Btu tax as far upstream as possible. The reason is that energy consumed throughout the production process should be taxed to create an incentive for efficiency improvements all the way through the stream.

And therefore we think, for example, energy is consumed in moving gas through natural gas pipelines; it is consumed in transporting oil and in transporting electricity. By taxing energy upstream, all of those energy uses will see the higher marginal costs, and therefore have the incentive to become more efficient.

Mr. PAYNE. I had a question. Mr. Andrews left when Mr. Hauptfuhrer spoke.

The administration has indicated that they do not yet know how they will treat the taxation of natural gas liquids under the Btu tax. Could you give us your views on how they should be treated?

Mr. HAUPTFUHRER. You are correct, there is no position that has been formulated on it and it is a complex problem. Natural gas liquids are used not only as an energy fuel but they are used as a feedstock for petrochemicals and they are also used as a blending component in the course of refinering and manufacturing so that some of them work themselves into other taxable fuels.

I think the most important thing that should be considered as that proposal is developed is to avoid double taxation. Second, if natural gas is consumed in NGLs as a fuel, that it be taxed as natural gas. Those are the two most important principles. But there are a number of uses for natural gas liquids that would qualify them for exemption in taxes to avoid the principle of double taxation and to achieve the exemption which was originally designed by the administration for petrochemicals.

Mr. PAYNE. Thank you very much.

I have one last question. Ms. Roy, you mentioned that due to IPP long-term contracts, you would not be able to pass along this tax. It is my understanding that in many of these contracts there are fuel adjustment clauses and that likely this tax would be able to be passed along through such clauses; is that not correct?

Ms. ROY. There are some like that, but most of the ones we looked at, we did a survey in the IPP in 1992 and none of the clauses allowed for energy taxes to be passed through.

Now, a subset of the industry has a price mechanism that is geared toward existing fuel costs. That is a relatively small percentage. And that way they would, with a time lag, they would be able to get and make up the fuel tax.

No one is suggesting in our industry that we make a profit from this. In the cases where that happens, we would kind of come up with a mechanism, that a wrinkle that we would address, to make sure that there was no windfall profits that some of these companies achieved. But the majority of these companies—and I can speak for Intercontinental specifically as well as for the industry in general—do not have the mechanism which would allow for the

pass through to be recaptured—I mean, allow for the tax to be recaptured. And I can go into details if you are interested on how those work.

Mr. PAYNE. Thank you very much. I appreciate that.

Mr. McDermott, do you want to inquire?

Mr. MCDERMOTT. Thank you, Mr. Chairman.

I read all of your testimonies with interest because I am interested in this whole area. Seattle just decided to make the largest purchase of natural gas powered buses in the history of the world. I think 360 buses. They are going to convert their whole system, and it is my belief that—actually I wrote an editorial suggesting that a gas tax of 50 cents was a good idea because it raised money but it would also push the environmental issues. So I am concerned that we continue pushing the development of alternative energy sources.

Mr. Alderson, I know that you are president of Kenetech and your subsidiary companies are involved in cogeneration and energy conservation and wind turbine manufacture, and I also know that you worked on a green tax package that we put on the energy bill when it was in the House of Representatives.

What I would like you to tell the committee is, what are the institutional impediments to greater utilization of renewable energy like wind? What kinds of things are standing between us and really developing those industries?

Mr. ALDERSON. Well, I think probably the first one is just the slow rate of change in the utility industry generally and I think at this stage wind has recently, through some technological breakthroughs, arrived to the point where it is cost competitive with most fossil fuel plants, which we also build and develop.

So at this point, I believe that the primary issue is to try and maintain the status quo, to allow utilities and companies such as ourselves to proceed with developments that are in process. Probably the two elements of this proposed legislation which we would find most interesting in that regard is the exclusion of wind and solar from the Btu tax, which we think would in essence undermine that which was accomplished last year; and then secondly, the offsets between the investment tax credits that are proposed reducing those production tax credits which were included in the last year's legislation.

I would point out that those production tax credits were designed to equate the already favorable tax treatment for a variety of fossil fuels that were in the bill. So it is that level playing field that we are most interested in retaining.

Mr. MCDERMOTT. Are there other things that any of you on the panel, including Mr. Alderson, can talk about the Tax Code that needs to be changed to make it possible for alternative energy development in the tax code particularly?

Mr. ALDERSON. As far as the Tax Code in particular, there is a long history of the passthrough of investment tax credits in conjunction with sale and lease-back transactions. The owner actually has the opportunity to pass the investment tax credit by an election to have the tax credit, which is an incentive to investment, be taken either by the owner of the equipment or the user of the equipment.

To the extent that we have that flexibility as a structuring option with these tax credits, then you can optimize the utilization of that tax incentive.

That starts from the premise that the incentive is there in the first instance to cause investment to occur.

Mr. McDermott. You are saying that incentive is now available to oil and gas but not to anybody else?

Mr. Alderson. Indirectly I would say that, but more to the point, including in either production tax credits or in investment tax credits as well as in accelerated depreciation, the ability to be used by either the owner of that equipment or the user of that equipment would be helpful and would allow the full benefit of these taxes to be taken.

Mr. Lashof. Mr. McDermott, if I could point out two things in my testimony that I didn't get a chance to talk about orally regarding energy efficiency encouragements through the Tax Code. One you alluded to is the green tax package in the energy bill which we certainly appreciate your leadership on.

One of the unresolved issues there because of the lack of offsets, the exclusion for energy efficiencies rebates paid by utilities, excluding that from being treated as income by IRS was not 100 percent in all customer classes, and I think there is an opportunity this year to complete the job that was started there and make that exclusion 100 percent in all customer classes.

A second proposal that I would make is the energy bill included a provision to start pilot projects for energy efficient mortgages in a number of States. It would be very desirable to create a tax incentive to the secondary lending companies so that they could, for example, earn tax-free income on just the energy efficiency components of those mortgages.

So, for example, the idea behind this program is you buy a house that needs energy-efficiency improvements, you can add $5,000 to your mortgage to pay for those improvements provided that it has been determined independently that those are cost-effective improvements.

The secondary lending market has been very reluctant to implement this program, which would have a number of economic stimuluses as well as environment. Providing the incentives for them to do that I think would be very high leverage, with a very small incentive, produce a lot of the activity both in terms of jobs and rehabilitation and energy efficiency improvements.

Mr. McDermott. I hope that the members of the panel, as they see issues that we can push in this committee in terms of energy conservation and the development of alternative energy sources, will bring them forward because I think as this country looks at its energy question and how we are dependent upon the rest of the world, the more stable it looks outside our country, the more important it becomes I think that we find ways to make ourselves energy independent. And I think we have an opportunity with President Clinton to turn the corner that was beginning to be turned under President Carter, but we stopped for 12 years and it is time to get back to looking at alternative energy sources.

So I appreciate your coming today and I hope that you will give us all the suggestions you have.

Thank you, Mr. Chairman.

Mr. PAYNE. I agree. Mr. Hauptfuhrer.

Mr. HAUPTFUHRER. I would just like to refer Mr. McDermott to a report that was completed in December of last year by the National Petroleum Council which identified vast resources yet to become reserves of natural gas in this country, which will help fuel those buses in Seattle and homes and around the country and so forth.

And so natural gas does represent the cleanest burning fossil fuel that we have, and is one of our options and it is in great supply assuming that the appropriate policies are not interfering with its use.

Mr. MCDERMOTT. We are looking into the impact on Seattle. They are working out the problems of venting buildings now and where they can have fueling sources, and I think once they have done it for all the buses in Seattle, it will then become much more available for regular automobiles and other kinds of commercial vehicles. We are looking forward to it as a real step forward.

Mr. PAYNE. I would like to thank the panel for their testimony. It was certainly very helpful to the committee and we will utilize it as we continue our deliberations.

Thank you very much.

Our next panel will testify on housing issues and the President's economic package. We have, from the Los Angeles County Community Development Commission, Carlos Jackson; from the National Low Income Housing Coalition, Karen Hill; from the Enterprise Foundation, Bart Harvey; the National Assisted Housing Management Association, Charles S. Wilkins, Jr., and the Local Initiatives Support Corporation, Paul Grogan.

All of your written testimony will be entered into the record, so that you might proceed as you wish with your oral testimony, and I would ask Mr. Jackson if he would proceed first.

STATEMENT OF CARLOS JACKSON, EXECUTIVE DIRECTOR, LOS ANGELES COUNTY COMMUNITY DEVELOPMENT COMMISSION

Mr. JACKSON. Thank you, Mr. Chairman, and members of the committee. It is really a pleasure for me to be accorded this opportunity to appear before the committee, and I say that in a selfish way, in that my presentation, or at least what I would like to share with you, are some major concerns to the county of Los Angeles. I make that as a distinction from the city of Los Angeles because, as a result of last year's civil unrest, there was extensive damage caused by fires, et cetera, in areas other than the city. Particularly, I would estimate 10 different jurisdictions within the county of Los Angeles.

I am representing an agency that is predominantly responsible for the economic development of the county of Los Angeles, as well as for the unincorporated county areas, where close to 1 million people are living in the unincorporated area and, including the 10 cities, the combined population could be 4 or 5 million people, where we have to look at ways to foster economic recovery.

Economic recovery challenges are compounded by the problems we are facing right now with aerospace downsizing. Over the last

few years, we have lost close to 100,000 jobs as a result of aerospace industry downsizing. Combined with other problems we are experiencing economically, California, overall, is really suffering. The county of Los Angeles itself, which has a $13 billion budget, is facing close to $1.2 billion loss of revenues.

So when we start looking at ways to revitalize the county, the Federal enterprise zone program is probably one of the most promising programs we can look at in terms of being an instrument to effectuate economic recovery.

If I may, I would like to also say that we support strongly the permanent reinstatement of the single family mortgage revenue bond program, and the low-income housing tax credit, because those are two vehicles that have helped us facilitate the provision of affordable housing.

I want to focus, really, on the enterprise zone issue, however. We support the concept of the Federal enterprise zone, but we do have some serious problems with the criteria, and, if I may, I would like to run through those briefly.

One deals with the size of the zones that have been discussed. There is presently a limit of 20 square miles. Los Angeles and the county is such an expansive area, 20 square miles would not begin to cover the area in need. The damage we have suffered extend well beyond 20 square miles.

We have presently a State enterprise zone, which was started in the 1980's, that covers 35 square miles. That alone only covers a portion of the county. And when we start looking at restrictive geographic limitations, it creates a severe hardship on us.

Second, is the question of the poverty criteria. The proposal uses the Department of Labor poverty rates. We recommend that Congress consider an alternative, such as using the income limits that are set for public housing. We feel that that criteria would give us more flexibility by allowing us to look at poverty rates that are regionally adjusted rather than unadjusted national averages that are established by the Department of Labor.

If I can highlight this quickly; if we used the Department of Labor poverty rates in the south central county of Los Angeles, there are 172 census tracts that we would examine. Under the poverty rates of the Department of Labor, only 30 percent would qualify for inclusion in a zone. Under what I propose, the public housing or section 8 income limits, 60 percent would qualify. So you can see that there is greater participation by areas in need of economic revitalization.

We have estimated that, if there is not an adjustment of the poverty rate, that close to a million to 1.5 million people would not be able to take advantage of the enterprise zone, thereby creating a hardship in terms of job creation, employment, et cetera.

Los Angeles County's unemployment rate now is close to 11 percent, and that is only the reported figure. We know that more people are unemployed than what is reported. So we have a severe economic hardship going on right now in terms of trying to create jobs. If we are to exclude certain segments geographically from the zone due to the poverty criteria, we would not be addressing the regional issue of recovery.

Los Angeles County is such an urbanized area, you cannot really make a distinction between cities in terms of the boundaries. They are neighbors. So it is hard to carve out an area, and if you limit your resources to one area, it will impact negatively the other communities.

The other point is that there is this criteria or factor in the proposed legislation of the State competitive process. We feel, and this is an excellent incentive through the Community Development Block Grant Program, that if you can keep the State out of the process, you will have a faster implementation of the program. If you involve another layer of Government, unnecessary delays will result.

Last, and this is a key point that I would like to really bring home, the State of California, is suffering economic hardship right now. There are massive proposed layoffs both at the State and local government levels. One of the reasons is there are no local resources to continue many of the services and programs that are State mandated to serve the public.

One of the factors in the enterprise zone concept is local match, a local in-kind contribution. However, the present concept does not allow us to use other Federal resources as local matches. We would not be able to provide non-Federal resources for local matches under present economic conditions. As I mentioned, our county budget is facing at least a $1.1 billion loss of revenues, and to impose another obligation such as that could be devastating. We would not be able to qualify, or compete effectively with other jurisdictions under those constraints.

Last, I think it is also important to look at how we can integrate into the program, commercial manufacturing areas adjacent to eligible census tracts under the enterprise zone. If the idea is for job creation and to retain jobs, we have to look at ways we can integrate those elements into the enterprise zone programs. Particularly areas that are already zoned for such activities so local governments do not have to go through a rezoning process.

Again, I want to restate we would like to support the enterprise zone concept, but we have to look at the facts and make sure there is flexibility and that we can be sensitive to the regional differences throughout the country. Thank you.

Mr. PAYNE. Thank you, Mr. Jackson.

[The prepared statement follows:]

TESTIMONY
BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
HOUSE WAYS AND MEANS COMMITTEE
PRESENTED BY CARLOS JACKSON
EXECUTIVE DIRECTOR
LOS ANGELES COUNTY COMMUNITY DEVELOPMENT COMMISSION
ON MARCH 23, 1993

Mr. Chairman and distinguished members, I appreciate the courtesy you are extending to Los Angeles County in permitting me to submit this testimony.

I am Carlos Jackson, Executive Director of the Community Development Commission, the agency in Los Angeles County which is responsible for the provision of affordable housing and community redevelopment and economic development programs. We administer the largest urban county Community Development Block Grant (CDBG) program in the nation and we are the second largest housing authority west of the Mississippi.

Los Angeles County's population of 9,285,490 is larger than 42 states in the nation. There are 88 incorporated cities in the County, and a population of about 1 million in the unincorporated areas of the County. One out of 6 county residents is on public assistance and the unemployment rate is approximately 11%, the highest for any area in this country.

While much of the country has rebounded from the recession, Los Angeles County is still in a state of depression. Based on a recent report released by the County's Aerospace Task Force, 100,000 aerospace jobs have been lost since 1988 because of defense cutbacks; and there is considerable doubt about a better tomorrow. It was projected in this report that in the next eight or nine years, there will be 184,300 fewer jobs in the County. Unemployment insurance will increase by $362.8 million and public assistance costs will go up by $147.4 million. The cumulative loss to the County's economy, in personal income and retail sales respectively, will be $86.4 billion and $23.8 billion. As a result of the weak economy, 122,000 fewer houses will be built and $6.3 billion less will be spent on commercial construction. We are facing a $2.27 billion loss in property and sales tax revenues. Los Angeles County needs help.

Please keep in mind, during your considerations, that the County and the City of Los Angeles are separate entities. The County is currently facing, in its 1993-94 revenue projections, a $1.1 billion deficit in its $13 billion budget. The County's only alternative is to consider massive reductions in public services, such as law enforcement and health programs. The ramifications of our County's problems are being felt nationwide.

There are three major programs that would significantly enhance the economic recovery efforts in Los Angeles County: Enterprise Zones, Housing Tax Credits, and Mortgage Revenue Bonds.

ENTERPRISE ZONES
Enterprise Zone designation criteria should be flexible enough to allow the inclusion of all economically distressed areas of Los Angeles County. The criteria for designation of enterprise zones is a critical issue for the County.

The County has many poor, blighted communities the suffered extensive damage in the April 1992 riots, and for which enterprise zone designation could be a significant recovery and development resource.

Areas within the County which would benefit from enterprise zone designation include, but are not limited to, the cities and unincorporated County areas primarily located south and east of the City of Los Angeles. These areas include Greater Watts, Long Beach, Compton, East Los Angeles, and sections of the San Gabriel Valley.

The current enterprise zone proposal presents several issues for the County, as did H.R. 11 last year, in that very needy areas would be precluded from inclusion in an enterprise zone due to the proposed designation criteria. For Federal Enterprise Zone legislation to significantly contribute to the improvement of our cities and County, it must address the following concerns.

Zone Size

The current proposal would limit size of zones to 20 square miles; the Greater Watts area alone is 35 square miles. In Los Angeles County, unlike much of the East where multi-story housing is predominant and creates very high density, 20 square miles severely limits the populations that could benefit. It is estimated that between 1.5 and 2 million needy residents in the Southeast Los Angeles County would be excluded from zone benefits under the current restriction.

The County recommends that the size of the zones be large enough to allow for the variation in our nation's urban situations. Further, we are hopeful that the legislation consider the designation of a sufficient number of zones nationally to permit consideration of multiple zones in Los Angeles County for maximum coverage of our needy areas.

Poverty Criteria

The bill also requires poverty rates that utilize a national average that places the County at a disadvantage. The rate is not adjusted for regional cost of living differences and inadequately reflects the plight of needy communities in Los Angeles County.

The County recommends that Housing and Urban Development (HUD) low- and moderate-income criteria, which are adjusted to allow for regional cost of living differences, be used rather than un-adjusted poverty rate criteria.

Moreover, many areas which are zoned for commercial and manufacturing uses may not qualify for inclusion in a zone due to the absence of residential uses which meet the poverty criteria. This has the effect of eliminating areas with existing vacant land and available vacant buildings where industry and jobs would be attracted in the greatest numbers. These areas hold the best prospect for immediate investment since re-zoning is unnecessary and property assemblage is easiest.

The County recommends that consideration be given to include in the zone an incentive program for commercial and manufacturing areas adjacent to qualifying census tracts.

State Processing
The legislation includes a requirement for a competitive process at the state level prior to Federal application, a process which would delay designation. As noted above, the 20 mile restriction limits the State from overlaying a federal enterprise zone over an existing State zone such as the Greater Watts zone in South-Central Los Angeles.

The County recommends that the competitive process required at the State level be eliminated.

Local In-kind Contributions
There is currently a prohibition against the usage of programs which are Federally funded to meet requirements for local "course of action" elements which will be rated in the zone selection process. The County and cities of Southern California remain strapped financially and would not be able to bear the additional cost burden of locally financed in-kind zone incentive programs without including the Federal funded programs.

The County recommends that local jurisdictions be allowed to meet "course of action" rating requirements through locally planned use of Federal funds and in-kind contributions.

Lastly, I would like to emphasize that tax incentives must be aimed at both small and large business development. The small business sector of our economy holds the best hope for creating the majority of job opportunities in Los Angeles County and our country.

I must say here, we are supportive of the specific requirements for businesses to employ local residents to receive tax incentives. As you know, unless community residents have a stake in the businesses and the development of their neighborhoods, positive long-term change in the lives of the families living in our cities will not occur.

A commitment to the establishment of a carefully crafted Federal Enterprise Zone program is an important step in our efforts to revitalize our communities. We hope the legislation ultimately addresses the concerns you hear today, and is enacted expeditiously to ensure that businesses and our communities know that federal and local governments are doing their part to aggressively reverse the decline of our inner cities.

HOUSING TAX CREDIT
We urge permanent reinstatement of the Low-Income Housing Tax-Credit Program. There is a profound need for affordable housing in Los Angeles County. It is not news that the County is one of the most expensive housing areas in the country. The median price of a single-family home is $206,000; more than twice the national average. Only 24% of all households can afford an average priced home.

- Of the 200,175 households receiving food stamps, 38% pay 51% to 79% of their income for rent and utilities, while another 23% pay 80% or more of their income for rent and utilities;

- The median rent in the County rose 132% in the last decade; and

- An estimated 40,000 garages are used as housing in the County.

The low-income housing tax credit has helped plug the enormous gap left by the past 12 years of diminished federal housing programs. Nearly 23,000 units received assistance from the tax-credit program in the first three years in California. That program, with its ability to leverage significant private investment into affordable rental housing, is invaluable.

MORTGAGE REVENUE BOND PROGRAM
We also urge that the Single Family Mortgage Revenue Bond Program be permanently extended. The program has been aggressively utilized in Los Angeles County. Since its inception in 1982, there have been 8,330 units, valued at $558,159,000, built for first-time homebuyers. Because residential construction creates jobs, we believe that it can be a major catalyst to the County's recovery. For example, according to the Construction Industry Research Board, for every million dollars spent for single- family residential construction, 28 jobs are created. In addition, Revenue Bond Program funds are used for home improvement loans to low- and moderate-income households.

The Low-Income Housing Tax Credit and Revenue Bond Programs are only two in a vast array of affordable housing programs which, if adequately funded, should meet the housing need in Los Angeles County. As Director of the County Housing Authority, I am deeply concerned about the more than 100,000 applicants on our Section 8 waiting list and their five-year wait for housing. Be assured that some of our elderly applicants will not outlive the wait. We need more Section 8 certificates and vouchers, and the Section 8 administrative fee must be fully funded.

Public housing has been a low priority over the past decade. Our County needs public housing development funds even more than funding for renovation in order to cope with the wait of several years for a public housing unit.

Yes, there is a wide variety of housing programs. But of what use are they if they are not sufficiently funded?

I have indicated the need for the funding of a variety of housing and community development activities in Los Angeles County. To pinpoint that need, the Community Development Commission surveyed the 50 cities which participate in the Los Angeles Urban County CDBG Program regarding the need for capital improvement and public service projects. The results of the survey are as follows:

- 1,240 proposed capital improvement projects

- 24 public service projects

- $438.3 million needed

- 10,528 jobs created

CDBG is one of the best and most effective programs to come out of Washington. It attests to the proposition that local government knows best how to deal with local problems. The Program deserves less criticism and more funding.

Congressional action on these matters would be most beneficial to Los Angeles County and the rest of the nation as well.

Mr. PAYNE. Ms. Hill.

STATEMENT OF KAREN V. HILL, CHAIR, NATIONAL LOW INCOME HOUSING COALITION, AND EXECUTIVE DIRECTOR, FAIR HOUSING IMPLEMENTATION OFFICE, YONKERS, NY

Ms. HILL. Mr. Chairman, my name is Karen V. Hill. I appear today as chairperson of the National Low Income Housing Coalition. I am also the executive director of the Fair Housing Implementation Office in Yonkers, NY.

The National Low Income Housing Coalition is a nonpartisan membership organization. Our members include low-income residents, community-based nonprofits, public agencies and allied professionals who share our goal for decent affordable homes for all people. I appreciate the opportunity to appear before you today to testify on the low-income housing tax credit.

The NLIHC has been deeply involved in the credit since its inception. The NLIHC first proposed the establishment of a credit in 1985, and led the broad coalition of national groups that helped secure its enactment in 1986. Our president, Barry Zigas, participated in the Mitchell-Danforth Tax Credit Task Force whose 1989 recommendations led to important reforms in the program.

Many of our members have successfully used the credit to provide desperately needed homes for low- and very low-income residents. We now seek support for the program's permanent extension and the adoption of specific amendments that will improve the program's ability to fulfill its original mission.

My testimony today will cover two key areas, a brief summary of the critical housing needs facing low-income Americans, and a summary of the amendments we hope you will consider to improve the credit and help it meet its stated goals more efficiently.

The recent HUD analysis of American housing survey information shows that 5.1 million very low-income renter households suffer from worst case housing needs. This means that they pay either half or more of their income for rent and utilities or live in substandard homes or both.

The trends also show that this group is growing, while the universe of homes that are accessible to them at 30 percent or less of their income has practically vanished. The bottom 25 percent of all renter households has grown since 1970 by more than 2 million households from about 6 million in 1970, to more than 8 million in 1989. Meanwhile, their median income has declined from nearly $11,000 per annum to just over $7,000 per annum. More households and more poorer households.

During the same period of time, the numbers of homes and apartments that rent for an amount at or less than 30 percent of income has declined from about 6 million units in 1970 to only about 2.8 million units in 1989. Since 1986, the low-income housing tax credit has played a critical and increasing role in the Federal Government's efforts to address these needs.

Under the current law, the credits must serve either households with incomes below 60 percent of the area median income, adjusted for family size, or 50 percent of the area median income. This is a vast improvement over previous tax expenditures for rental housing, however, as the HUD analysis of the American housing survey

shows, the vast majority of those with the most pressing housing needs cannot afford even the reduced rents that are available through the tax credit program alone.

Anecdotal evidence from advocates for the poor suggest that working poor families and racial minorities can face obstacles in gaining access to these units. HUD itself has concluded in its latest study of worst case housing needs that;

> Because of the design of the low-income housing tax credit, units that receive no other rental subsidy will tend to have incomes near the 60 percent cutoff rather than the much lower incomes characteristic of renters with worst case needs.

The tax credit clearly helps many sponsors and developers renovate and produce high quality affordable rental housing. Long waiting lists for units are but one testament of the urgent needs that tax credits help fill. However, in considering where to extend the credit, Congress should be aware of who can and cannot be served under the credit's present requirement.

The National Low Income Housing Coalition believes that the Low-Income Housing Tax Credit Program is an essential tool that attracts private capital investment to housing for low-income residents. However, we remain concerned that the program itself is unable to provide the low-income rents to those that need them the most.

Therefore, we urge you to consider an amendment that would do one of two things: The first would be to require every tax credit project to set aside at least one-third of the units for households with incomes at or below 35 percent of the area median income with rents that are affordable to them. This would require Congress to provide specific additional set-asides of section 8 project-based assistance or some other additional subsidy to ensure that the projects could be run with such low rents.

Alternatively, we urge you to require that all State allocating agencies give absolute priority in allocating their credits to any projects that propose to provide units for such households at rents that are within their reach. Rents in the credit program are not set according to the resident's income but as a fixed percentage of the qualifying income. Section 8 rental assistance is absolutely critical for very low income households to be able to pay these rents.

Other Federal housing construction programs prohibit discrimination against section 8 voucher and certificate holders to ensure that these households will have access to homes built with Government assistance. This provision should be included in the low-income housing tax credit program as well.

The Uniform Relocation Assistance Act mandates that families displaced by federally funded activities receive moneys for moving expenses and a 3½ year rental housing assistance. The requirement should also apply to the LIHTC projects. Under current law, an owner may purchase a building housing very low income people, renovate it with the assistance from the tax credit, and rerent it to tax credit-eligible households who may have higher incomes than those displaced by the acquisitions. Those who lost their homes are not eligible for any assistance whatsoever.

Since the availability of tax credit subsidies is directly linked to the acquisition and displacement, the URA requirements should be the minimum standard to which all tax credit sponsors are held.

Every Federal housing program supported by directed expenditures includes a requirement that residents be protected from arbitrary actions by a good cause eviction requirement. This should also be incorporated in the tax credit program.

Current rent and income restrictions remain in force for 30 years although owners can opt out of these restrictions after 15 years if no buyer willing to retain the low income use can be found. We recommend that Congress act now to extend the use restriction to at least 55 years to avoid the loss of those units to the affordable housing stock.

This requirement should specify that use restrictions could be temporarily lifted in the event that the financial feasibility of the project was threatened. Investors should continue to be able to sell their interest to a preservation buyer after the initial compliance period, as under current law.

The statute should be amended to make HOME funds eligible for the higher credit amount. This is one of the last LIHTC/HOME conformity issues remaining after the passage of the Housing and Community Development Act of 1992. Making HOME funds eligible for the higher 70 percent credit would enable sponsors to serve lower income households by drawing more private capital to the project.

In connection with the permanent extension of the program, we urge Congress to mandate a regularly scheduled review to evaluate the overall development, administrative and operating costs of tax credit projects, as well as their success in achieving their stated purpose, their coordination with other Federal housing assistance programs, and the characteristics of residents living in tax credit homes. Such an effort could be undertaken by an impartial nongovernmental agency.

Costs and margins for tax credit projects will vary depending on the type of household and neighborhood served. The study should take into account that projects that serve lower-income residents in distressed neighborhoods may carry greater transaction and operating costs due to the increased complexity and challenges of sponsoring and operating the projects. Any study should consider all the variables that might affect costs in light of the public purpose to be served.

And, finally, we propose that the fair housing certifications, affirmative marketing and reporting requirements that now apply to other HUD housing programs be explicitly incorporated in the low-income housing tax credit requirements.

In my very own community in Yonkers, NY, where we are trying to overcome four decades of intentional racial discrimination in housing, one of the few ways in which we will be able to serve the class members at the lowest rung of the economic scale, those between 30 and 35 percent of the area median income, with both affordable housing opportunity, new construction, and to overcome desegregation is through the use of the low-income housing tax credit program with this provision added.

And, finally, we are not limiting our scope to an evaluation of the low-income housing tax credit. We would urge Congress to also look at the mortgage interest tax deduction and ways in which reforms

can be implemented there so that we can put more money into the pipeline to serve lower income and very-low-income residents.

I thank you.

Mr. PAYNE. Thank you.

[The prepared statement follows:]

TESTIMONY OF KAREN V. HILL
National Low Income Housing Coalition

Mr. Chairman, members of the Committee, my name is Karen V. Hill. I appear today as Chairperson of the National Low Income Housing Coalition. I am also the Executive Director of the Fair Housing Implementation Office in Yonkers, NY. The National Low Income Housing Coalition is a nonpartisan membership organization. Our members include low income residents, community-based nonprofits, public agencies and allied professionals who share our goal of decent, affordable homes for all people.

I appreciate the opportunity to appear before you today to testify on the low income housing tax credit. The NLIHC has been deeply involved in the credit since its inception. NLIHC first proposed the establishment of a credit in 1985, and led the broad coalition of national groups that helped secure its enactment in 1986. Our President Barry Zigas participated in the Mitchell-Danforth Tax Credit Task Force whose 1989 recommendations led to important reforms in the program. Many of our members have successfully used the credit to provide desperately needed homes for low and very low income residents. We now seek support for the program's permanent extension and the adoption of specific amendments that will improve the program's ability to fulfill its original mission.

The NLIHC has always noted that tax-driven subsidies are inherently less efficient than direct investments in affordable housing for low income people, such as grants or even direct loans. However, we have also recognized that the resources allocated to the credit are not available through direct grant methods. We have supported the credit, and I appear here today to support its permanent extension, because we believe that despite its inefficiencies, it represents an important source of investment capital for desperately needed affordable homes for low income renters. I am also here to recommend certain amendments to the credit that we believe will enhance its effectiveness.

My testimony today will cover two key areas:

- a brief summary of the critical housing needs facing low income Americans today, and the extent of federal involvement in direct spending programs to meet those needs;

- a summary of amendments we hope you will consider to improve the credit and help it meet its stated goals more effectively.

Low Income Housing Needs

Low income people face a ferocious housing crisis. Millions of families are trapped in a vicious cycle of poverty because of the huge amounts of their income which they must pay for rent. These are the "hidden homeless," who are one paycheck or family crisis away from the shelter system and the welfare hotel. These are the families who have been forced to double up in the homes of friends or families, and who will end up homeless unless they can find alternative housing at a price they can afford.

The lack of affordable housing for millions of Americans--and the nightmare of homelessness it has spawned--is the most critical social issue confronting the nation in the 1990's. The crushing rent burdens which poor people pay for their homes are locking. some families into poverty, and driving others from a tenuous hold on economic self-sufficiency. Yet 50 years after the federal government committed to eradicate housing need in this country, only one-third of all American families who meet the government's own test of need are receiving federal housing subsidies. As Figure 1 illustrates, participation in federal housing assistance programs is low--about 28 percent--even among poverty-level renters, whose income is substantially below the federal test of "very low income" for purposes of housing assistance programs.

Recent HUD analysis of American Housing Survey information shows that 5.1 million very low income renter households suffer from "worst case housing needs." This means that they either pay half or more of their income for rent and utilities, or live in severely substandard homes, or do both. Of these 5.1 million, 3.6 million are families or elderly individuals. The balance are single non-elderly adults. Moreover, the incidence

of "worst case housing needs" is concentrated primarily among those with the lowest income even in this group. Households with incomes below 30 percent of the area median -- close to the poverty level in most metropolitan areas for a family of four -- are the most severely affected by the housing crisis. Moreover, they are most likely to suffer from a housing cost burden. In other words, they pay half or more of their income for housing, but do not suffer from physical housing problems such as deterioration or overcrowding.

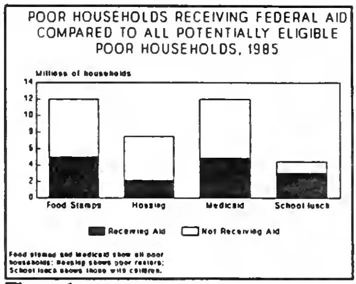

Figure 1

Families with children and those with disabilities are the most likely to suffer a combination of these housing needs.

The housing crisis hits those with the lowest income the hardest. Recent trends show that this group is growing while the universe of homes that are accessible to them at 30 percent or less of their income has practically vanished. The bottom 25 percent of all renter households has grown since 1970 by more than 2 million households, from about 6 million in 1970 to more than 8 million in 1989. Meanwhile, their median income has declined from nearly $11,000 per year to just over $7,000 per year. More households, and more poorer households. During this same period of time, the number of homes and apartments that rent for an amount at or less than 30 percent of this income declined, from about 6 million units in 1970 to only about 2.8 million in 1989. Figure 2 graphically shows this trend.

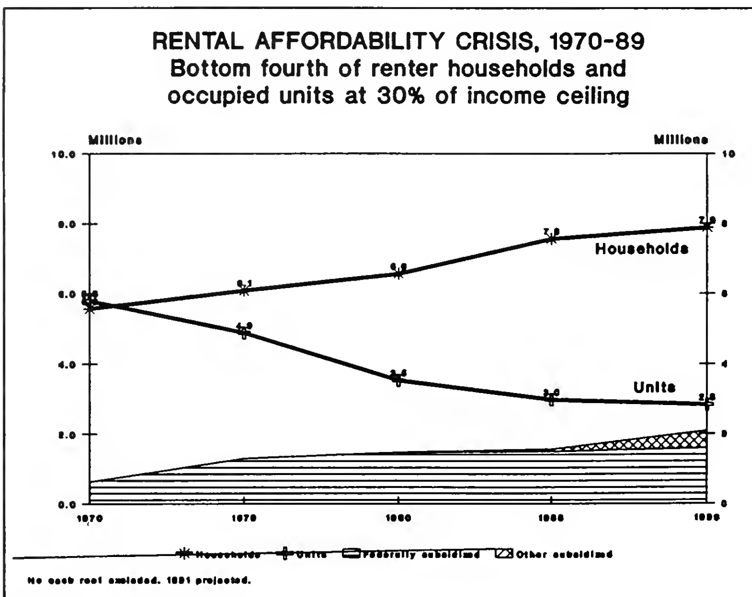

Figure 2

Although the high cost of housing remains the most fundamental problem facing low income people today, millions of Americans still cannot find decent housing at any price. This is especially true in rural areas where credit is not available, and where poor families often still live in homes without running water. In large cities and suburbs and towns, the same is true for large families, the disabled, single adults and many elderly.

Structurally unsound housing remains a problem throughout the country. In 1983, 4.5 million homeowners and 5 million renters occupied housing that did not meet minimum quality standards. The absolute number of low income families living in substandard housing increased by 20 percent from one million in 1973 to 1.2 million 10 years later. Twenty-six percent of renters with incomes below $5,000 occupied structurally unsound housing, according to a recent study by the Joint Center for Housing at Harvard University.

While the supply of government subsidized housing has increased since such programs first began in 1937, the federal Department of Housing and Urban Development (HUD) now provides subsidies to only about 4.5 million households.

The Impact of Recent Federal Policies on Homelessness and Housing

Since 1981, the federal government has withdrawn from low income housing development and support. In contrast to policies pursued throughout the 1960's and 70's, the Reagan and Bush Administrations and Congress have in the 1980's greatly reduced overall federal financial commitments to low income housing, and reduced the options available to carry out low income housing efforts through repeal or termination of various programs.

During Fiscal Years 1979-81 HUD provided housing assistance to an *average* of 261,000 additional families each year. During the 12 years of the Reagan-Bush Administration, the yearly average has plummeted to less than 85,000 families. The FY94 budget proposed by the Clinton Administration unfortunately does little to reverse this sorry trend. The budget proposes only an additional 40,000 Section 8 Vouchers next year, along with basically level funding among production programs like HOME, public housing and other categorical efforts. Other elements of the economic recovery plan, such as the increase in the Earned Income Tax Credit and other social investments that are long overdue, may help to increase incomes among low income and working poor households. If so, housing cost burdens should be lowered somewhat. Some of these households may find their housing options increased as a result. But for the vast majority of those most affected by the housing crisis, the need will not be assuaged by the Clinton budget proposal.

The impact of this withdrawal at the state and local level has been substantial. State and local programs which gained prominence during the 1970's and 1980's have largely failed to make up for the diminution in federal assistance because they were designed primarily to complement substantial federal resources. Moreover, state and local governments have themselves faced severe budget constraints as a result of economic decline, reduced federal assistance across a broad range of program areas, and reduced tax revenues brought about by the federal tax Code changes of 1981 and 1986.

Improving Administration of the Low Income Housing Tax Credit

Since 1986, the low income housing tax credit has played a critical and increasing role in the federal government's efforts to address these needs. Under the current law, the credits must serve either households with incomes below 60 percent of the area median income, adjusted for family size, or 50 percent of the AMI. This is a vast improvement over previous tax expenditures for rental housing. However, as the HUD analysis of the American Housing Survey shows, the vast majority of those with the most pressing housing needs cannot afford even the reduced rents that are available through the tax credit program alone. Anecdotal evidence from advocates for the poor suggests

that working poor families and racial minorities can face obstacles in gaining access to these units. HUD itself has concluded in its latest study of worst case housing needs that "...because of the design of the LIHTC, units that receive no other rental subsidy will tend to have incomes near the 60 percent cutoff rather than the much lower incomes characteristic of renters with worst case needs." [HUD, Dec., 1992]

Better Targeting

The tax credit clearly helps many sponsors and developers renovate and produce high-quality, affordable rental housing. Long waiting lists for units are one testament to the urgent needs that tax credits help fill. Data from the National Council of State Housing Agencies and others also indicate that as a result of other reforms in the treatment of rental real estate in the 1986 tax act, the LIHTC now accounts for a very significant portion of all rental production and rehabilitation throughout the country.

However, in considering whether to extend the credit, Congress should be aware of who can and cannot be served under the credit's present requirements. Figure 3 shows the relationship between tax credit rents, HUD's 1991 Section 8 Existing Fair Market Rents, and rents that would equal 30 percent of both a 50 percent of area median income and a 35 percent of area median income in selected metropolitan areas.[1]

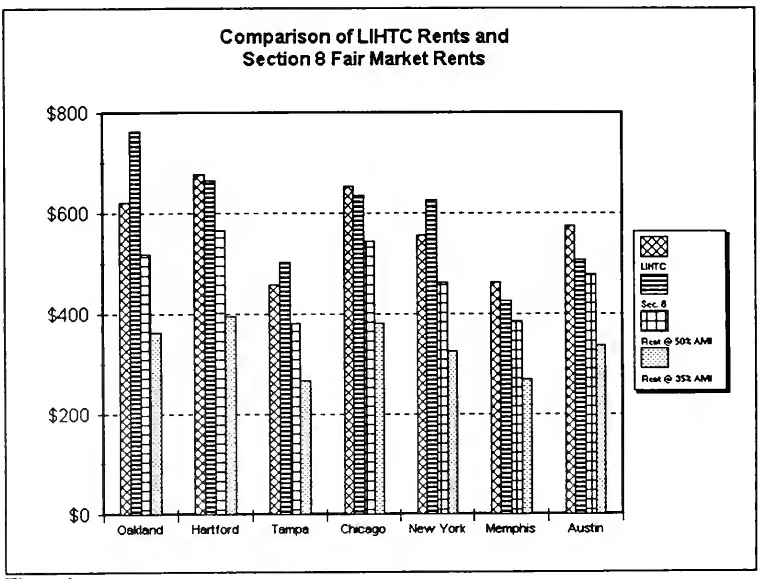

Figure 3

The Section 8 Fair Market Rent is calculated by HUD to equal the 45th percentile of all rents in the area for modest apartments and homes, excluding

[1]. The FMR figures are for a two-bedroom unit and are published by HUD for each SMA. The median income figures are for a family of four from 1992, and were obtained from HUD, who produces them for the Section 8 program. Tax credit rents for a 2-bedroom unit are calculated against a 3-person family. The rents were derived by taking 90 percent of the AMI (the HUD adjustment for a 3-person family) and then taking 30 percent of that figure for each SMA. The rents at 50 and 35 percent of AMI were obtained by using the same base.

government assisted homes and homes constructed or rehabilitated within the last 2 years. The tax credit enables sponsors to reduce rents in most cases to within the same range as these FMRs. In Oakland, the reduction is quite significant. This is the good news for LIHTC projects. They enable sponsors to produce new or rehabilitated homes at prices that approximate those charged for existing properties in the same area, while presumably offering the quality improvements that should apply to newly built or rehabilitated buildings.

In all cases, however, the tax credit rents are significantly higher than rents that would be affordable to either those at 50 percent of AMI or 35 percent of AMI. The tax credit rent would equal 36 percent of a 3 person household's income at 50 percent of the AMI, while it would consume 51 percent of such a household's income at 35 percent of the AMI. In all of these areas, an income of 35 percent of the AMI is above $10,000 per year. In Chicago and Hartford it is above $15,000 per year, which is about the median income for all renters throughout the country. It is well above the national poverty level for a family of three.

Incomes for Selected Metropolitan Areas

Metro Area	Median income, family of 4	35% of AMI, adjusted for family of 3
Oakland	$46,000	$14,490
Hartford	$50,200	$15,813
Tampa	$33,800	$10,647
Chicago	$48,400	$15,246
New York City	$41,100	$12,947
Memphis	$34,200	$10,773
Austin	$42,600	$13,419

These figures are representative of the rest of the country. HUD research using the American Housing Survey shows that nationally, FMRs range from 41 percent to 76 percent of the 3-person AMI. The purpose of the Section 8 program is to offer very low income residents subsidies that will enable them to rent such homes in the private marketplace. Congress correctly assumes that those with the greatest housing needs cannot afford even rents that are slightly below the median for all existing homes.

Comparison of LIHTC Rents in Selected Metro Areas

Metro Area	LIHTC Rent	Sec. 8 FMR	Affordable Rent @ 50% AMI	Affordable Rent @ 35% AMI
Oakland	$621	$763	$518	$362
Hartford	$678	$665	$565	$395
Tampa	$456	$503	$380	$266
Chicago	$653	$635	$545	$381
New York City	$555	$625	$462	$324
Memphis	$462	$425	$385	$269
Austin	$575	$506	$479	$335

The National Low Income Housing Coalition believes that the low income housing tax credit program is an essential tool that attracts private capital investment to housing for low income residents. However, we remain concerned that the program itself is unable to provide affordable rents to those who need them the most. Therefore, we urge you to consider an amendment that would do one of two things. The first would be to require every tax credit project to set aside at least one-third of the units for households with incomes at or below 35 percent of the AMI with rents that are affordable to them. This would require Congress to provide specific additional set asides of Section 8 project-based assistance or some other additional subsidy to insure that the projects could be run with such low rents. Alternatively, we urge you to require all state allocating agencies to give absolute priority in allocating their credits to any projects that propose to provide units for such households at rents that are within their reach.

Tax credit projects can be successfully developed to serve these households. Many nonprofits, working together with state and local governments, already have succeeded in meeting requirements similar to these so that tax credit units serve those with the worst housing needs. They require additional public subsidy investments to bridge the gap between what these extremely low income households can pay for rent and what the homes actually cost to own and operate. Congress should facilitate this targeting either by establishing a new setaside and providing the funds necessary to finance it, or by fostering more cooperative ventures at the state and local level by requiring state allocating agencies to give projects that seek to serve these households absolute priority in the allocation of funds.

Prohibition of Discrimination Against Subsidy Holders

Rents in the credit program are set not according to the resident's income, but as a fixed percentage of the qualifying income (either 50 percent or 60 percent of area median). Section 8 rental assistance is absolutely critical for very low income households to be able to pay these rents. Other federal housing construction programs prohibit discrimination against Section 8 Voucher and Certificate holders to insure that these households will have access to homes built with government assistance. This provision should be included the LIHTC program as well.

Relocation Assistance

The Uniform Relocation Assistance Act mandates that families displaced by federally funded activities receive moving expenses and three and a half years of rental housing assistance. The requirement should also apply to LIHTC projects. Under current law, an owner may purchase a building that houses very low income people, renovate it with assistance from the tax credit, and re-rent it to tax credit-eligible households, who may have higher incomes than those displaced by the acquisition. Those who lost their homes are not eligible for any assistance whatsoever. Since the availability of tax credit subsidies is directly linked to the acquisition and displacement, the URA requirements should be the minimum standard to which all tax credit sponsors are held.

Good Cause Eviction Requirements

Every federal housing program supported by direct expenditures includes a requirement that residents be protected from arbitrary actions by a "good cause eviction" requirement. This should also be incorporated in the tax credit program.

Long-Term Use Restrictions

Current rent and income restrictions remain in force for 30 years although owners can opt out of these restrictions after 15 years if no buyer willing to retain the low income use can be found. We recommend that Congress act now to extend the use restriction to at least 55 years to avoid the loss of these units to the affordable housing stock. This requirement should specify that use restrictions could be temporarily lifted in

the event that the financial feasibility of the project was threatened. Investors should continue to be able to sell their interests to a preservation buyer after the initial compliance period, as under current law.

Rights of First Refusal

Under some LIHTC partnership agreements, non-profit sponsors are given the right of first refusal to purchase the housing at below market prices. The minimum price is the cost of the debt plus the owner's exit taxes. The cost of the exit taxes is usually prohibitive for community groups. Low income families would be benefitted by waiving the duty of the purchaser to pay those taxes if the seller agrees.

Fair Housing Requirements

We propose that the fair housing certification, affirmative marketing and reporting requirements that now apply to other HUD housing programs be explicitly incorporated as LIHTC requirements.

Higher Credit Percentage for HOME /LIHTC Projects

The statute should be amended to make HOME funds eligible for the higher credit amount. This is one of the last LIHTC/HOME conformity issues remaining after the passage of the Housing and Community Development Act of 1992. Making HOME funds eligible for the higher 70 percent credit would enable sponsors to serve lower income households by drawing more private capital to the project.

Comprehensive Evaluation of the Program

In connection with the permanent extension of the program, we urge Congress to mandate a regularly scheduled review to evaluate the overall development, administrative and operating costs of tax credit projects, as well as their success in achieving their stated purpose, their coordination with other federal housing assistance programs, and the characteristics of residents living in tax credit homes. Such an effort could be undertaken by an impartial nongovernmental agency. Costs and margins for tax credit projects will vary depending on the type of household and neighborhood served. The study should take into account that projects that serve lower income residents in distressed neighborhoods may carry greater transaction and operating costs due to the increased complexity and challenges of sponsoring and operating the project. Any study should consider all the variables that affect cost in light of the public purpose served.

Mr. Chairman, I appreciate the opportunity to share our views on this important subject. I will be happy to answer any questions that you may have.

Mr. PAYNE. Mr. Harvey.

STATEMENT OF F. BARTON HARVEY III, VICE CHAIRMAN AND CO-CHIEF EXECUTIVE OFFICER, ENTERPRISE FOUNDATION

Mr. HARVEY. Thank you, Mr. Chairman, for the opportunity to testify on behalf of permanent extension of the low-income housing tax credit.

I must start by thanking the persistence and the perseverance of this committee. I testified before you in 1989, 1990, 1991, 1992, and today, and there was movement for permanent extension of the tax credit in 1989, 1990, 1991, 1992, and today, and I don't know whether it is still spring training season in baseball, and hope spring's eternal, but I think now is the time for permanent extension. We certainly hope that it will happen this year.

The Enterprise Foundation is a national nonprofit that is deeply involved in the tax credit. The Enterprise Foundation serves in 100 communities, including Lynchburg, and works with 325 nonprofits across the country. It has over 800 million in investment and commitments with a superb record of return. A great majority of its investment comes through the low-income housing tax credit and goes to nonprofits for desperately needed housing.

Let me cut to the quick on some of the key points for retaining this tax credit. First of all, it supplies virtually all of the affordable rental housing in the country today. I think it is over 94 percent. And that is over 100,000 units a year. Second, it is a terrific stimulus tool, in that it provides—and the estimates vary here—from 65,000 to 90,000 jobs, but it is not only the jobs, it is the right kind of jobs.

The Local Initiatives Support Corporation and Enterprise work extensively together in some areas, and these jobs go to small contractors, in a lot of cases minority professionals are involved in the nonprofit work, and these jobs also go to nonprofit developers. So it really hits in the inner cities where we do our work and where a lot of other stimulus proposals do not hit.

There are those who say that the tax credit should not be used for housing, it is an indirect allocation method, or that it costs too much. And there is a little known fact outside of this committee room, and that is that basically most of the housing in this country is done through the Tax Code. In 1992, Federal housing tax expenditures were $70.3 billion and $67 billion of that went to homeowners, and the great majority to those making over $50,000 a year.

So in terms of equity, the low-income housing tax credit is less than 1 percent of the expenditures through the Tax Code and it goes to the neediest people in the country, which are renters, who have half the median income of homeowners. So it is a small amount to ask when you are looking at the Federal Tax Code.

You might also note that housing done through the Tax Code, that goes to families making more than $50,000 a year, far exceeds everything that is expended for low-income people through direct allocation and also through the Tax Code. There are some costs in the program, which are the cost of collecting investors and the cost of paying directors. You have to balance that against the cost of assembling a staff at HUD to make sure that there is an allocation

of an appropriated program as well as the staffs in the city and the States to make sure that those programs are properly worked.

We think the costs are reasonable. We think there is a business discipline that occurs in the use of tax credits, and that the Federal Government only spends a tax credit if the project works for 15 years. And that that is a pretty good tradeoff for the business discipline and for some of the costs of this program. There are also risks that private investors undertake.

I stress permanent tax credit extension because it has been a stop-start program to date, and there is no way that you can build on the momentum when you do not know year to year whether the program is going to continue. There is an 18 month or greater housing cycle that you have to contend with, and you will not get the kind of people in the for-profit side working on this program if they never know whether it is going to be there or not.

For nonprofits, this is an absolutely critical program. There is a 10 percent set-aside, but nonprofits far exceeded that in what they use of the low-income housing tax credit, and it is essential to most of the groups that we work with and it reaches some of the worst-needs housing in this country.

There are improvements that can be made. I agree with many that Karen put forward. I think that there are also some program changes that need to be made in it, particularly as far as HOME funds go. This is a new appropriated program and it should link well with the tax credit. And the way that it is set up right now, is if you use HOME funds instead of CDBG funds, which are basically the same kind of funds, you get a much lesser credit. It just simply doesn't make sense. There is proper regulation of how these programs are combined. It leads to great inefficiency in trying to use appropriated funds with the tax funds.

Thank you very much.

Mr. PAYNE. Thank you very much, Mr. Harvey.

[The prepared statement follows:]

Statement of
F. Barton Harvey, III
The Enterprise Foundation
Before
The Committee on Ways & Means
United States House of Representatives

March 23, 1993

Mr. Chairman, Congressman Archer, and members of the Committee, thank you for the opportunity to participate in this hearing on behalf of The Enterprise Foundation and share our thoughts concerning the Low Income Housing Tax Credit ("Tax Credit"). I am Bart Harvey, vice chair and co-chief executive officer of The Enterprise Foundation.

Your long-standing support of the Low Income Housing Tax Credit has meant that many low-income Americans have decent, affordable housing. We are deeply grateful for your leadership and that of the Tax Credit's stalwart champion, Congressman Rangel. We thank you and Congressman Rangel for introducing H.R. 18 that provides for a permanent extension of the Tax Credit and for your efforts to ensure its inclusion in the House budget resolution. We hope, Mr. Chairman, that you and your colleagues who have overwhelmingly supported annual extensions of the Tax Credit on a bi-partisan basis will permanently extend this important program.

We are very heartened that President Clinton has called for a permanent extension of the Tax Credit in his economic package, the first such time a President has ever proposed a permanent extension. He is strongly supported by HUD Secretary Cisneros who shares the President's view that the Tax Credit is an economic stimulus that invests in both human and physical capital. In his previous capacities as an active trustee of The Enterprise Foundation and Mayor of San Antonio, Mr. Cisneros gained a first-hand knowledge of the Tax Credit's essential role in the low-income housing delivery system.

First and foremost, Mr. Chairman, we lend our unqualified support for permanent extension of the Tax Credit. The disruption created by the lapse in the credit, which expired June 30, 1992, means the loss each month of 10,000 units that would otherwise have been produced by the Tax Credit for low-income people. To put a human face on these costs, think of this as more than 300 units lost per day:

-- That's triple the size of the Shalom House Tax Credit project, renovated by the nonprofit ecumenical organization, So Others Might Eat (SOME), that houses minimum wage earners, the disabled, and fixed-income elderly located here in northeast Washington, D.C.

-- Congressman Rangel, as you well know, 300 units is roughly equal to the combined total Tax Credit units for the Canaan Baptist Church Housing 2000 project, Catholic Charities' Gema Hall project, West Harlem Community Organization's projects, Community League of W. 159th's projects, and El Barrio's Pleasantville Apartments and La Casa projects. All are serving many formerly homeless people and working poor people. Imagine those neighborhoods without these anchors of stability, and you get a keen sense of what the current credit expiration means in human terms.

-- And, Congressman Lewis, you can draw a parallel situation with the recently opened service-enriched Welcome House, a 209-unit new construction project serving working poor individuals and many formerly homeless people, some who had been living under a nearby freeway.

Beyond the human dimension, a lapsed credit means that signficant economic benefits are foregone -- a loss of 66,000 construction jobs per year if the credit is not extended, according to the National Association of Homebuilders (NAHB). But if permanently extended, capital can be steered into a highly productive and needed segment of our economy, the rehabilitation and construction of affordable housing. Each unit produced by the Tax Credit generates $140,000 of economic activity in wages and tax revenues -- in all a total of $16.8 billion per year. NAHB also estimates that the Tax Credit produced 52,000 jobs in 1992.

Permanent extension of the Tax Credit will also impel an ad hoc system of investment, development, and leverage to become more efficient, predictable and reliable. It will also allow the economic benefits of housing production and rehabilitation to accrue to the array of small developers, contractors, builders, and "rehabbers" that typically work on Enterprise types of projects - small (20-40 units), inner city, and for very low income.

While we understand the political realities that necessitate including the Tax Credit in the budget reconciliation measure, we cannot underscore enough the effects in both human and economic terms that this credit lapse is creating. Furthermore, the delay is jeopardizing the viability of the very able, but resource lean, nonprofit housing delivery system. Enterprise has taken several actions to ensure that it is able to immediately respond to the equity financing needs of the nonprofit housing delivery system upon enactment of a Tax Credit extender. Let me mention briefly two efforts that are illustrative of this readiness:

o First, through our subsidiary Enterprise Social Investment Corporation (ESIC), we will introduce by this summer a second Corporate Housing Initiatives Fund (CHI). CHI invests in properties oriented to homeless people and those with special needs. Its Housing Plus entity socially underwrites each project to assure that suitable human services are provided to achieve independent living. It filled an enormous need in the market and brought in investors, led by Fannie Mae with a $10 million commitment and followed by $27 million from other major corporate investors. Given the need and the success of CHI, the second fund will be attractive to other socially-motivated investors.

o Second, we recently announced the formation of the Nations Housing Fund, subject to to approval by the Office of the Comptroller of the Currency. A $100 million commitment from NationsBank, this is the single largest one-time commitment by a Tax Credit investor. We applaud the forward thinking of NationsBank. They are willing to pledge the equity up front, with no certain extender, because they have seen the need in communities, and they are convinced of the effectivess of the Tax Credit's public-private partnership.

The Enterprise Foundation and its History with the Tax Credit

The Enterprise Foundation is a publicly supported 501(c)(3) charitable organization working in over 100 cities, with more than 300 nonprofit neighborhood groups. Our mission is to see that all poor people in the United States have the opportunity for fit and affordable housing within a generation and to move up and out of poverty into the mainstream of American life.

The Foundation was launched in 1982 by its chairman Jim Rouse and his wife, Patty. Mr. Rouse had the privilege to serve at the request of Congress as chairman of the National Housing Task Force. Its recommendations provided a blueprint for a new national housing policy and was the basis for the landmark housing bill, The Cranston-Gonzalez National Affordable Housing Act of 1990. As part of a comprehensive national housing policy, the task force recommended permanent extension of the Low Income Housing Tax Credit.

Enterprise was called on by Congress to help shape the Low Income Housing Tax Credit legislation when it was enacted in 1986. In 1988, we were asked to share our experience with implementing the program, and I served on the Mitchell-Danforth Task

Force which reviewed the program's progress and suggested changes which would facilitate its usefulness.

In our work throughout the country, The Enterprise Foundation assists grassroots nonprofit groups with their programs to rebuild housing and community in some of the most distressed and poorest neighborhoods in the country. Enterprise has provided these local groups with "seed" capital in grants, loans, and equity investments to create 25,000 units of housing for very low-income people. To date, Enterprise has put into nonprofit sponsored housing more than $500 million that has been leveraged many times over with private sector, state, local and federal financing.

In tandem with this seed capital, Enterprise builds and expands the capacity of local groups to become highly productive and proficient nonprofit housing developers. We are constantly experimenting and seeking new ways of financing and developing low-income housing that is both economical and deeply rooted in local communities. We share extensive technical "know how" in the lowest cost means of rehabilitating buildings, seek ways to link housing with appropriate community services, and offer a wide array of financial packaging services and sophisticated real estate development expertise.

We are greatly concerned that the housing we help to develop is enduring and sensitively managed in its neighborhood context. Enterprise works closely with the people of the neighborhoods, with local leaders, and with local governments to understand the problems and find answers. We try to restore the lives of people as well as the buildings and neighborhoods.

One of the most important tools that we employ in our work throughout the country is the Low Income Housing Tax Credit. Our experience with the Tax Credit illustrates how the resources and creativity of the free enterprise system can be harnessed for the public good and contribute to the well-being of our nation's people and our economy.

The Enterprise/ESIC Experience with the Tax Credit

Since enactment of the Low Income Housing Tax Credit in 1986, the Enterprise Social Investment Corporation (ESIC), a wholly-owned subsidiary of The Enterprise Foundation, has raised $650 million in equity investments from over 130 of America's major corporations that will produce over time more than 26,000 units of low-income housing. By forging partnerships among business, government, and local nonprofits, ESIC has become one of the leading sponsors of institutional investment in low-income housing nationwide.

Nonprofit groups are increasingly active as developers of low-income housing. ESIC has stepped in to provide direct technical assistance and financial packaging services to these nonprofits and to lend its expertise in states with a less sophisticated nonprofit delivery network. ESIC finds equity investors, structures the partnership, assists in project development issues and oversight, lends differing levels of on-going technical assistance to projects, and in many cases, acts as a special limited partner with on-going monitoring responsibilities.

ESIC typically assists community-based nonprofits in a variety of adverse and tight housing markets, such as in inner cities and poor rural areas. The program has been used to put a large number of tax delinquent, city-owned, in rem units back into productive low-income use in such markets as *New York City, Chicago, Baltimore, Los Angeles, Dallas, Washington, D.C.* and many other cities. It has helped mitigate, with new rehabilitated units, the effects of rent increases triggered by the repeal of investment tax incentives and the decline in the production of such units subsequent to the Tax Reform Act of 1986.

The Tax Credit is designed to work in all parts of the country, enabling ESIC to structure national and regional Tax Credit equity funds as well as individual low-income housing Tax Credit projects to address a variety of low-income housing needs. In addition to the Nations Housing Fund and Corporate Housing Initiatives Funds mentioned previously, ESIC's national funds include:

o *Enterprise Housing Partners* I & II provides equity financing to nonprofit and for

profit developers for the preservation and creation of low-income housing. Corporate investor commitments to this fund total $28 million with a lead commitment from Freddie Mac. ESIC recently introduced Enterprise Housing Partners II (1992), which has thus far raised $15 million toward a $50 million goal.

o ***The Housing Outreach Fund (HOF)*** was launched to provide critically needed equity to smaller, primarily nonprofit-sponsored projects across the country. The fund has provided equity to projects in 18 states: ***California, Colorado, Connecticut, Florida, Idaho, Illinois, Maine, Nebraska, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Vermont and Virginia.*** Fannie Mae is the investor in this $35 million fund.

ESIC's regional funds include:

o *New York City* - ESIC has helped generate 5,000 units of housing for low-income and homeless people. In 1988-89, ESIC structured syndications for 1,000 units with Fannie Mae, American Express, Brooklyn Union Gas Company and Pfizer. Currently, ESIC is a co-general partner with the National Equity Fund (a subsidiary of LISC) to manage $179 million in three funds providing equity for the development of 4,000 low-income and single room occupancy (SRO) units in the five New York boroughs.

o *Atlanta* - In 1991, ESIC and the Atlanta Neighborhood Development Partnership (ANDP) established the Atlanta Equity Fund which has raised $5.5 million to date.

o *Cleveland* - ESIC first helped structure five successful individual project syndications of 188 units involving Cleveland Tomorrow, an association of CEOs of Cleveland's 50 largest corporations. Following this success, ESIC was asked to organize a $4 million fund, the Cleveland Housing Partnership, that has invested in an additional 400 units. In 1991, two new funds were organized, the Cleveland Neighborhood Equty Fund and the Cleveland Enterprise Housing Equity Fund. Commitments of $6 million are now in place from local and national corporations for these two initiatives. ESIC provides direct fund management and underwriting support to Cleveland Housing Partnership, Inc., the funds' general partner.

o *Cincinnati* - ESIC structured syndication of 180 units in the Over-the-Rhine neighborhood. The Procter & Gamble Company was instrumental in bringing seven corporations together to pledge $4.5 million toward this effort. Procter & Gamble led the formation of a second pool with approximately $5 million committed to date.

o *Florida* - ESIC worked with the nonprofit Greater Miami Neighborhoods to establish the Florida Housing Tax Credit Fund. Seven local investors have committed $3.85 million to the fund and another $3 million has been committed by national corporations.

o *Maryland* - The Maryland Housing Equity Fund I placed $7.5 million in equity to produce 438 housing units statewide. Maryland Housing Equity Fund II, launched in late 1991, is now capitalized at $6 million. ESIC also serves as the general partner of the Maryland National/Enterprise Equity Fund, a $10 million fund established by a single investor. Between 1986-88, ESIC structured individual syndications for 270 units of affordable housing in Maryland.

o *Michigan* - ESIC is working with the Michigan State Housing Development Authority to establish an equity fund.

o *New York State* - In conjunction with Shearson Lehman Brothers and Related Capital Corp., ESIC was chosen by the State of New York to organize a $56 million statewide equity fund for the New York State Housing Trust Fund and serves as managing general partner.

o *North Carolina* - ESIC is working with the North Carolina Housing Finance Agency to establish a statewide equity fund. ESIC will be the general partner of this fund with a subsidiary of the agency serving as co-general partner.

o *Ohio* - The primary goal of the Ohio Equity Fund is to provide a readily available source of equity for smaller projects in rural areas and small cities, not served by citywide equity funds. The fund is a joint venture of the Ohio Capital Corporation for Housing and corporate investors. This has been an important capacity-building demonstration for involving local poverty agencies (CAP agencies) and small housing authorities. In 1990, $7 million was committed for nine developments involving 280 units. In 1990 and 1991, ESIC assisted in placing an additional $8.1 million in equity for 10 projects involving 299 affordable housing units.

o *Philadelphia* - ESIC has syndicated three low-income housing projects sponsored by nonprofit developers, forged a working relationship with the Philadelphia Urban Affairs Partnership and is under contract with the redevelopment authority to syndicate rehabilitation of 98 units in North Philadelphia. ESIC is working with CoreStates Bank (formerly Philadelphia National Bank) to establish a new metropolitan area equity fund, The Delaware Valley Equity Fund. ESIC serves as general partner of this fund which raised $6.1 million from local Philadelphia investors.

o *Pittsburgh* - The $5.25 million Pittsburgh Equity fund has been organized with the Pittsburgh Partnership for Neighborhood Development.

o *Rhode Island* - The Rhode Island Housing & Mortgage Finance Corporation enlisted ESIC to establish a $5 million statewide fund, and a second fund is now forming.

In addition, ESIC has structured individual Tax Credit projects in ***Baltimore, Maryland; Columbia, Maryland; Durham, N. Carolina; Los Angeles, California; Philadelphia, Pennsylvania; Portland, Maine; San Francisco; California; Washington, D.C.; and Wilmington, Delaware.***

Because ESIC typically works in very poor and distressed areas, most projects need a substantial amount of other subsidy monies to be financially viable. Often, in addition to assistance from ESIC, The Enterprise Foundation gives technical assistance and makes grants and low-interest loans to local nonprofit groups for their predevelopment costs, operating support, or other project-related support service costs. This assistance is largely made possible by private foundations and charitable contributions from individuals. Construction loans or bridge financing typically come from banks and governmental entities. ESIC's presence ensures that all the money raised from corporations through the use of Tax Credits is put back into the project or used to support additional low-income housing.

In economic terms, corporations invest in ESIC-sponsored projects for the stream of tax benefits generated. The return on their equity investment reflects the anticipated transfer of projects to the nonprofit sponsor at the end of the required 15-year holding period through sale or contribution rather than anticipation of an outright gain or windfall profit on sale. In this way, the longevity of low-income occupancy beyond the required use period is assured and low-income families are not subjected to the painful and costly dilemma, as in the current case, of either preserving the existing stock of federally-insured projects now eligible for prepayments or allowing displacement and conversion to other use of higher income people.

Beyond the provision of housing for low-income people, the most important achievement of ESIC's experience with the Tax Credit has been its role in nurturing a delivery system of community-based, nonprofit housing production. It is the potential of this delivery system that led the National Housing Task Force to some of its important recommendations.

The Enterprise Foundation finds that a variety of community-based efforts are emerging to address the housing and support service needs of low-income and homeless people. The Enterprise Foundation, often through ESIC, will initially work with concerned church groups, a local affordable housing committee, or a homeless service provider interested in learning to become a nonprofit housing developer.

Established community development corporations, known as CDCs, and experienced nonprofit housing developers are also important members of the delivery system's network.

In its 1991 report, *Changing the Odds: The Achievements of Community-based Development Corporations*, the National Congress for Community Economic Development reports that since the mid-1980s, there has been a 60 percent increase in the level of housing production done by community-based development corporations (CDCs). The report notes that CDCs have produced 320,000 units of housing for very poor people, and that production has greatly accelerated in recent years. Clearly, the Tax Credit, which has generated nearly 600,000 low-income rental units since 1987, is significantly fueling this production level.

The Tax Credit serves to build delivery system capacity by acting as a catalyst for established and emerging nonprofits to forge partnerships with corporations, lenders, government. According to 1991 estimates made by the National Council of State Housing Agencies (NCSHA), nonprofit participation overall was approximately 14 percent of all 1991 tax credits allocated. In some states, the percent allocated greatly exceeded the required 10 percent set-aside for community-based nonprofits, as in Rhode Island where 51 percent of credits were awarded to nonprofits, and Vermont (79 percent). NCSHA reports that in other states, including Connecticut, Illinois, North Carolina and Pennsylvania, over 25 percent was awarded to nonprofits.

Enterprise strongly believes that a permanent extension of the Low Income Housing Tax Credit is essential if this new delivery system is to be sustained and expanded.

The Case for the Low Income Housing Tax Credit

Mr. Chairman, I wish I were here today to tell you that we don't need a Tax Credit for housing because all Americans are well housed.

But a growing number of Americans are homeless or paying burdensome amounts of small incomes for substandard housing. Today, the nation's 9.6 million poorest renter households are competing for a supply of what has now dwindled to only 5.5 million affordable units, *a shortage of 4.1 million units.* The federal Department of Housing & Urban Development estimates that over 5 million households with incomes below 50 percent of area median are paying more than half their income for rent, live in substandard housing, or both. Only a third of all poor renter households receive any federal or state housing assistance.

If affordability were the only dimension to low-income housing needs, the solution would be more straightforward. But, unfortunately, it is not our sole challenge, and the supply of low-cost, decent housing is extremely deficient. An analysis by the Joint Center for Housing Studies of Harvard calculates that 3.8 million unsubsidized renters lived in units classified as structurally inadequate in 1989. Furthermore, among unsubsidized poor renter households, 1.1 million live in structurally inadequate units. The need for the Tax Credit as a production mechanism is also underscored by the fiscal constraints of the HUD budget. The lion's share of the HUD budget, each four of five dollars, must now be dedicated to maintaining affordability and current commitments versus adding to the supply. Only the Tax Credit, at its steady production capability of 120,000 units per year can make a truly significant effort at expanded low-income supply.

While housing needs expanded over the last twelve years, housing appropriations were cut by more than 75 percent during the previous two Administrations. Under the vigorous leadership of Senate Housing Subcommittee Chair Barbara Mikulski and strong housing supporters in the House, that landslide was stemmed in recent years. Nonetheless, federal outlays on low-income housing assistance programs totaled an estimated $19 billion in fiscal 1992 out of total outlays of $1.3 trillion, only slightly more than one percent of the federal budget. Federal housing-related tax expenditures in 1992, on the other hand, amounted to $70.3 billion, nearly $67 billion alone for homeowners. Again, however, very little is dedicated to low-income housing out of these tax expenditures.

Federal housing subsidies have evolved into a system where more than 95 percent of housing-related tax expenditures benefit the 65 percent of Americans who are homeowners. Conversely, 35 percent of Americans are renters who benefit from only 5 percent of federal

housing tax expenditures. While some 3.4 million households with incomes below 50 percent of area median struggle to pay rents consuming 74 percent or more of their income, the richest five percent of American households (4.3 million with incomes above $100,000) claim an average benefit of $3,500 per year in mortgage interest deductions.

Quite simply, it is a political fact of life that more housing policy is accomplished through the tax code than through outright appropriations from the federal government. As we seem certain to continue down this road, we should at least make this system as equitable, compassionate, and sound as possible. Let me make the case for why the Tax Credit should be a ***permanent*** feature of any such scheme:

Permanent extension is sound public policy. Increasing the supply of low-income housing is a long-term job that will reach well into the 21st Century. The Joint Center for Housing Studies of Harvard University reports that today's level of multifamily starts is well below that required to accommodate even the modest projected increases in renter households -- let alone allow for replacement of units demolished or otherwise removed from the inventory.

How well we do the job of meeting one of our country's most critical domestic needs will be a measure of our continued influence as a world power and competitive nation. If we cannot care for our own needs, we will not be in a position to compete, let alone lead.

Housing our people so that they can raise their children, care for elderly parents, work, and pay taxes, requires that we have a functional and productive low-income housing production mechanism. We do. In its six-year lifespan, the Low Income Housing Tax Credit has become the mainstay of low-income rental production. State agencies, government, business, and nonprofits all are expeditiously working together to sustain a very productive system. It now generates 120,000 units annually. How important is this level of production? **It represents virtually all multifamily low-income rental housing produced annually in the U.S.** In fact, one in three of all multifamily rental housing units produced last year was generated by the Tax Credit. Nearly all of these units will rent for less than $450 per month.

This is a program that has earned certain continuity, not an annual wrangle of "to be or not to be." Imagine the outcry if each year American homeowners had to wait until Congress adjourned to know if their mortgage interest would be deductible. The annual uncertainty adds costs, discourages good developers from getting involved, and holds hostage new commitments to the complicated system of producing rental housing.

Permanent extension is a critical long-term investment. No greater investment in America can be made than the investment in our people. With millions huddled in doorways, on grates, and in wretched, overcrowded housing, many of America's cities look more like a third world slum than a modern center of power. Given the on-going pressure of the federal deficit, we must direct available federal resources to reach those in need. We would estimate that the alternative, paying for the conditions generated by a lack of decent, affordable housing, greatly exceeds the cost of rectifying the situation.

When Congress created the Low Income Housing Tax Credit as part of the 1986 reforms, it recognized the tremendous need to create a highly targeted tax incentive directed at providing affordable housing for low-income renters. The credit was designed and has proven to reach very low-income people. At least 20 percent of each project must be occupied by households below 50 percent of area median or 40 percent below 60 percent of area median income. *Only* the targeted low-income units are eligible for the credit.

The Tax Credit's record has demonstrated that Congress responded in a sound, compassionate way to the needs of low-income citizens in this society. It is making an investment for a future rather than paying even more for a lack of policy, through health care

costs, shelter costs, prison costs, crime costs and lost opportunity costs. Furthermore, the Tax Credit's low-income targeting and the nonprofit set-aside features help ensure that a good deal of its benefits are propelled toward sectors of the economy -- such as small contractors, minority firms, and small businesses in inner city, very low-income neighborhoods -- that general economic stimulus merely skims over. Enterprise also finds in its work in typically small scale (20-40 unit) inner city projects that the Tax Credit stimulates job creation through resident management and other employment opportunities based within the project, such as day care centers. Often such jobs are the first rung in the ladder of opportunity to economic self-sufficiency for a family or formerly homeless individual.

Permanent extension is equitable. Given an historical and successful tax policy regarding encouraging homeownership, primarily through mortgage interest deductions and property tax deductions, the Tax Credit is meant to help those who can not afford homeownership. The rental population in this country has a median income approximately one-half that of its homeowner population. Clearly the most need is for affordable rental housing, and given today's housing costs and economic conditions, little low-income rental housing can be produced without the Low Income Housing Tax Credit or other subsidies.

The price tag for permanently extending this provision, the only encouragement for such housing, is $4.9 billion over six years compared to almost $70 billion in annual homeowner deductions, the great majority of which benefit families with incomes well above that of the rental population. That is an outlay each year less than one percent of that provided primarily for much wealthier families.

In summary, permanent extension is sound policy, a good investment, and equitable. I would, however, mention our implementation experience with amendments adopted in recent years and suggest some changes to the program and its administration which would further enhance its value.

Program Issues Affecting the Credit's Effectiveness

Mr. Chairman, we were deeply gratified to see the enactment in recent years of a number of changes to the program that greatly improve its effectiveness in serving low-income Americans. Among these, the adoption of an extended use provision addressed a serious design flaw in the original Tax Credit program. Extending the required low-income use period from the original 15 years to 30 years was a wise policy. It was accomplished at no additional loss to the Treasury nor diminishment in usage or demand for the program. The viability and possibility for permanent preservation of Tax Credit financed stock was greatly enhanced by extending the right of first refusal for tenants, nonprofits, tenant cooperatives, resident management corporations, and governmental agencies to purchase their individual units at the end of the initial 15-year low-income compliance period.

The 1990 amendments also included a much needed refinement to the definition of a qualified nonprofit organization to ensure that the minimum 10 percent set-aside of tax credits is protected, as Congress intended, for bona fide nonprofits clearly oriented to addressing low-income housing needs in their community. Housing credit agencies were given the specific responsibility for determining that nonprofits qualifying for the set-aside are not affiliated with or controlled by a for-profit organization.

We have also found that the allocating agencies have moved swiftly to implement their increased administrative responsibilities concerning establishment of "Qualified Allocation Plans," as required by the 1989 amendments. This has led to more solid evaluation and sounder underwriting activities by the agencies to ensure that credits granted do not exceed the amount necessary for the financial feasibility of the project, and we believe that the allocating agencies will responsibly fulfill the 90-17 subsidy layering review requirements, as mandated by the 1992 housing act, with a sensitivity to the fundamental variables that shape any single project, especially those developed by nonprofit, community-based housing organizations. We also believe that the implementation and development of the qualified allocation plans, which are subject to public scrutiny and input, can lead to improved low-income targeting and longer term low-income use. Overall, this is a rational approach that properly demands greater responsibility and accountability of federal resources in exchange for the states and localities to be given the flexibility to address locally-

determined needs and priorities.

The 1990 amendment restoring the eligibility of projects using McKinney Moderate Rehabilitation Single-Room Occupancy (SRO) funds has proved crucial to providing permanent, affordable housing for homeless people. Special needs housing is the toughest housing to develop, manage, and maintain. Properties are often in inner cities in very low-income communities where the entire social and economic structure has collapsed. Coping with cuts in social services makes it even more difficult to design programs that will adequately serve the project residents. Nonprofit, community-based organizations are often the only "infrastructure" willing to spend the effort to undertake this kind of housing. Often, these groups do not have a track record, and The Enterprise Foundation or ESIC provide technical assistance and predevelopment expenses. As federal, state, and local housing funds have become scarcer, commitments from a multiplicity of funding sources -- sometimes eight or more -- are painstakingly obtained. Projects tend to be small, well under 50 units is common. Not surprisingly, it is extremely difficult to attract investors and lenders as they perceive these projects as very risky business. But it can be done, as we have with our Corporate Housing Initiatives fund, if we demonstrate soundly structured projects, and the development process is streamlined as much as possible.

Suggested Program Amendments & Oversight Issues

In suggesting any further amendments to the Tax Credit program, Enterprise is committed to ensuring that the program continues to serve low-income people without imposing unduly burdensome, costly, or unworkable program requirements on the low-income delivery system.

<u>HOME Program and Higher Credit</u>. Enterprise has long supported a program change that would greatly increase the productivity and usefulness of the Tax Credit by treating the HOME Investment Partnerships funds the same as Community Development Block Grants (CDBG) for purposes of allowing the 70 percent present value credit. Under current law, Tax Credit projects involving federal subsidies are limited to the 30 percent present value credit. A federal subsidy includes any "below market Federal loan."

In recognition of the essentially "local" rather than "federal" character of CDBG funds, an exception was carved out allowing the higher 70 percent present value credit for Tax Credit projects involving CDBG funds. The basic rationale was that CDBG funds are distributed by formula grants to eligible states and localities for redistribution to locally identified projects. As such, the funds "lose" their federal character. The HOME program, enacted in The Cranston-Gonzalez National Affordable Housing Act of 1990 operates similar to the CDBG program. Eligible states and localities receive funds based on a formula and assign funds to individual housing projects based on needs locally identified in a Comprehensive Housing Affordability Strategy. HOME funds can be awarded to individual projects in a variety of forms, including grants, deferred loans, and low interest loans -- all of which categorize it under the below market Federal loan definition, thereby limiting Tax Credit projects involving HOME funds to the 30 percent present value credit.

HOME was conceived as a flexible program to provide gap financing for deeply targeted low-income housing projects. Inherent in the notion of gap financing is that it is intended to compatibly work with other public subsidies, including the Low Income Housing Tax Credit. By limiting the amount of each subsidy which can be used in a project, Congress forces developers to line up many different sources of subsidies, each with usually non-compatible regulations, adding significant legal, accounting, regulatory, time and process costs. Since Tax Credit allocating agencies must evaluate the total amount of subsidy necessary for a project anyway, it does not serve sound public policy to force low-income developers to use many sources of subsidy rather than a few. The current limit on HOME/Tax Credit projects serves only to <u>add</u> to costs and complexity, and that confusion can mask potential abuse. HOME funds were meant to help rectify this situation, not add to the problem. Allowing the higher credit with HOME would enable the state regulatory agencies to more easily scrutinize projects and readily identify rates of return.

The Clinton Administration views the HOME program as part of its long-term

investment strategy and as HUD's main production and rehabilitation mechanism. President Clinton recently issued a directive to unleash regulatory impediments to its implementation. We believe that amending Section 42 to allow the higher credit in conjunction with the HOME program enhances the stimulus and investment potential of both programs in support of President Clinton's objectives.

Service Space in Projects Serving Special Needs. Linking community services with the housing produced is an activity which Enterprise finds vital to creating stable environments and achieving independent living for low-income people, especially formerly homeless and transitional tenants. This activity would be facilitated by amending Section 42 to meet the management needs of such projects to allow the inclusion of the portion of the eligible basis of a project, up to a maximum of 20 percent. Current law limits this determination at the building level rather than at the project level. As such, the current law is not workable for low-rise multi-building projects, which by reasons of physical configuration, cannot limit the supportive services space to 20 percent or less of a particular building.

Tenant Purchases. In 1990, Congress extended the right of first refusal for tenants, nonprofits, tenant cooperatives, resident management corporations, and governmental agencies to purchase units at the end of the initial 15-year low-income compliance period. To clarify the intended interaction of the right of first refusal and extended use provisions, Section 42(h)(6)(E)(i) should be amended to terminate the extended low-income use restriction if the purchase occurs after the initial 15-year compliance period. Under current law, the extended use commitment requires that the owner and any successor owner maintain the property as low-income rental housing for 30 years. If a resident or nonprofit, for example, exercises the right of first refusal at the end of the initial 15-year compliance period to create homeownership, the purchaser would be in technical violation of the extended use commitment because the property would no longer constitute low-income rental property. Congress, in creating the right of first refusal, obviously intended that it override the extended use restriction in such instances, but a clarifying amendment is needed.

Long-Term Low-Income Use. We believe that Congress should be vigilant in its oversight of the Tax Credit program to ensure that its intended low-income beneficiaries are served to the greatest extent possible for the longest possible term. In 1989, Congress directed the allocating agencies to develop "Qualified Allocation Plans," including the requirement that agencies give preference to projects serving the lowest income tenants for the longest periods. We commend those state agencies which have implemented strong criteria that competitively rewards those projects serving the very neediest for the longest possible term. To ensure long-term low-income use, Enterprise structures its Tax Credit projects to utilize the right of first refusal upon the project's transfer to the nonprofit sponsor at the end of the required 15-year holding period through sale or contribution. We believe that this is one viable mechanism that can provide allocating agencies with tangible evidence on which it can base its determination to give an absolute preference in exchange for the long-term, low-income to be achieved.

Carryforward Rule & Unallocated Pool Credits. The carryforward provisions should be amended to give allocating agencies a full 24 months in which to allocate their $1.25 per capita credits and return credits. Under current law, allocating agencies must use all of their per capita and returned credits before they can allocate carryforward or pool credit. Enterprise also supports amending the program to provide that pool credits not allocated by the end of the allocation year are returned to the pool for reallocation the following year. Mr. Chairman, we are also appreciative of your efforts urging Secretary Bentsen to reconsider Treasury Ruling 93-18 that has reduced the amount of 1992 unused credits that allocating agencies may carryforward for allocation in 1993. This is a $41 million cost in Tax Credits for 28 states, $23 million of which may be permanently lost. We share your view that this is not an outcome that was intended by Congress. These credits are needed to keep the low-income rental production system in motion wherever possible, especially during this period that the credit has lapsed altogether.

Anti-Displacement. In our work throughout the country, Enterprise has an absolute anti-displacement policy. We believe that it is appropriate for the allocating agencies to adopt a strong anti-displacement policy in conformance with federal Uniform Relocation Act

or comparable state or local law.

Non-Discrimination. Fair housing is a fundamental component of national housing policy. Enterprise believes that the nation's fair housing and civil rights laws should be vigorously enforced, and that certifications of compliance, affirmative marketing, and lease and grievance procedures are appropriate mechanisms that should be required for projects assisted by Section 42. Furthermore, project owners should be prohibited from discriminating against Section 8 certificate or voucher holders.

Conclusion

In closing, I praise the perseverance, patience and energy of this committee to allow us to come before you each year in 1989, 1990, 1991, 1992, and now to plead our case. We urge you, as you consider the many important needs of this country, to ensure that a signficant part of tax expenditure policy is destined for rebuilding our country's communities. The permanent extension of the Low Income Housing Tax Credit is a mainstay of a national long-term investment strategy.

Thank you.

Mr. PAYNE. Mr. Wilkins.

STATEMENT OF CHARLES S. WILKINS, JR., PRESIDENT, NATIONAL ASSISTED HOUSING MANAGEMENT ASSOCIATION, AND EXECUTIVE VICE PRESIDENT, NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

Mr. WILKINS. Thank you, Mr. Chairman, for the opportunity to participate in these hearings. I am the president of the National Assisted Housing Management Association, which represents the managers of privately owned federally assisted housing across the country. We are dedicated to preserving the existing inventory of housing to delivering high quality housing, every unit, every day, to every family living in our properties.

Karen spoke quite effectively, I think, about the shortage of affordable housing in this country. The existing inventory which NAHMA members manage comprises roughly 2 million units, most of which are occupied by households making under 50 percent of median income. So these are the households most difficult to serve and the ones where the need is the highest.

These units were developed mostly 10 to 30 years ago. They have aging physical systems, roofs, heating systems, parking lots, windows. For the most part, these properties are well capitalized; they are viable and financially sound. Most of these properties will be able to sustain themselves with their own resources. However, some of them will need external financing.

NAHMA feels the low-income housing tax credit is an ideal vehicle for the rehabilitation of this housing where it is appropriate. The tax credit has the advantage that it does not add to the rent burden of the housing. It is important to us and to the people who live in the housing that the rent be the lowest that is consistent with sound management of the housing. The tax credit does not add to the burden, and we, therefore, support it as a vehicle for the preservation of this housing.

Without the necessary tools to address the preservation of the housing, some of these 2 million units of existing privately owned federally assisted housing will be at risk. We propose today that the low-income housing tax credit receive technical amendments to make it more usable for this housing.

There are two problems with the way the credit works today. The first is that this relates to the situation of an existing property where new investors are brought in in order to bring capital to the property for rehabilitation. The new investors would only receive a portion of the credits. This is inequitable because the new investors are bringing the entire amount of new capital into the housing.

The second problem is that the existing investors suffer dilution and, in most cases, fairly severe recapture problems with tax liability. As an illustration, take an existing property which has a value of $6 million. Say that it needs $6 million of rehabilitation. We have new investors who are willing to come in and contribute the $6 million, and they wish to do it under the low-income housing tax credit program.

Under existing procedures, the new investors would only be entitled to 50 percent of the credits, even though they are bringing all of the new capital. In addition, the existing investors would be di-

luted by half of their existing investment. So this would be the equivalent, at the 50 percent level, of a foreclosure.

In the written testimony, we use examples of an additional $2 million of taxes to pay for the existing investors. This is an unfair and unworkable situation. What we propose is that a technical amendment be enacted which would, in effect, create a new partnership or a new entity which would be deemed to have made the investment in the rehabilitation, so that the new investors would be deemed to have made an investment in this new entity. This is similar to the way section 42(e) works today, where for purposes of allocating the credit, the rehabilitation is deemed to be a new building.

What we are proposing is that it also be used to affect the allocation of the credit inside the existing partnership. So the new investors would come in, they would contribute the new capital, and they would receive the credits associated with that. Similarly, the existing investors would be deemed to retain the interest in the existing property and would not suffer the dilution and recapture which is present under the current rules.

We think that this solution is essential so that the credit can be useful in preserving existing housing. Currently, there is no easy way out of this dilemma, and I speak to this as the president of a trade association whose members have wrestled with this for several years.

The customary solution is to buy out the existing investors entirely and trigger the tax liability and use a good portion of the proceeds of the tax credit to cover that tax liability. As managers of the housing, we feel that that is inefficient. The existing investors should be allowed to stay in, their tax liability should not be triggered, and the credit should go entirely to the rehabilitation of the property.

This maximizes the usefulness of the credit, it minimizes the amount of credit dollars needed to accomplish preservation of a given property, and we recommend this strongly to the committee for consideration.

So, in summary, in the case of rehabilitation of previously syndicated rental housing, it is apparent the current IRS rulings for allocating the credit are frustrating Congress' intended purpose in enacting the credit.

I am pleased that President Clinton has proposed a permanent extension of the credit and we at NAHMA regard this as an important core provision of the President's program. The credit is one of many tools which are needed to promote the development of affordable housing. At the same time, I urge this committee to enact the technical amendments I have suggested in order that the tax credit will be maximally useful for the preservation of existing affordable housing as well.

Thank you.

Mr. PAYNE. Thank you, Mr. Wilkins.

[The prepared statement follows:]

Statement of Mr. Charles S. Wilkins, Jr.
President, National Assisted Housing Management Association

Before the Committee on Ways and Means
U.S. House of Representatives

March 23, 1993

Continuation of Public Hearings on
President Clinton's Proposals for Public Investment
and Deficit Reduction

Mr. Chairman, I thank you and your colleagues on this Committee for the opportunity to participate at these hearings on President Clinton's economic and budget program. I am President of the National Assisted Housing Association, NAHMA, representing the professional managers of privately owned, Federally assisted housing.

NAHMA is dedicated to providing affordable, decent, safe and sanitary housing to every resident household, every day, through sound management, working in partnership with HUD and other interested parties. In the face of a critical national shortage of affordable housing, it is essential to preserve the existing stock of affordable housing, and it is to that end that I appear before you today.

There are in excess of two million units of privately owned, Federally assisted apartments in the national assisted housing inventory, providing homes to over five million Americans with low and moderate incomes, providing direct employment to roughly seventy-five thousand American workers, and supporting local economies across America.

Assisted housing properties were developed as much as thirty years ago. These properties have aging building systems such as roofs, appliances, flooring, heating systems, parking areas and windows. Although most of these privately owned, privately managed properties are physically and financially sound and will be able to maintain and replace their aging systems without external financial resources, some properties will need new financing.

Debt financing is not always the most desirable route because the debt service increases rents, which is contrary to the purpose of the housing. Also, absent additional funding for rental assistance low income residents may be adversely affected. Moreover, there is a lack of sources for debt financing. Equity financing is a more desirable solution for these properties, and the Low Income Housing Tax Credit is the best equity financing approach available for affordable housing.

Mr. Chairman, without the necessary tools to address the capital needs of this inventory, which in some cases is well over twenty years old, much of it will be at risk. The use of the LIHTC to address preservation needs will move us closer to the goal of ensuring that this housing resource is maintained.

The basic rules governing the allocation of profits and losses (and therefore, the Low-Income Housing Tax Credit) provide, in effect, that tax credits derived from a particular enterprise are allotted to the owners of that enterprise in a manner proportionate to their ownership interests. Thus, for example, if limited partners own 99% of a low-income rental project, they would receive 99% of the profits, losses and tax credits derived from that ownership interest. Of course, as this Committee knows well, actual situations can be far more complex and there are exceptions to the rule, but the basic principle remains.

However logical this might seem, two problems arise in situations where low income rental property owners want to bring in new investors to provide funding for necessary rehabilitation. First, because the tax credits will be allocated proportionately to all owners, the new investors will be denied the credit arising from the rehabilitation to the extent of the existing owners' interests. This is fundamentally unfair, because it is the capital contributed by the new investors which enables the project to be rehabilitated.

The powerful disincentive that this inevitably provides for investment in rehabilitation can be understood from the following example. Consider a project currently worth $6 million, which may need another $6 million for rehabilitation. If new investors are admitted to the owner partnership, and the new investors provide the needed capital and secure the additional mortgage financing which enable the $6 million in rehabilitation work to be performed, the new investors will have been responsible for 50% of the overall value/cost of the total project and might reasonably be given a 50% interest in that project. <u>Consequently, under the current I.R.S. allocation rules, they will be entitled to only 50% of the Low-Income Housing Tax Credit, despite the fact that their entry provided all of the basis for the tax credit being obtained in the first place.</u>

Second, these allocation rules create a corresponding problem for the existing owners. Because the entry of new investors dilutes their partnership interest, the existing owners are likely to face negative tax consequences. If, for example, the project discussed above carried a $5 million mortgage and if the project's basis had been depreciated to $1 million, the admission of new partners acquiring 50% of the total value would make the existing investors subject to taxes on 50% of the excess of mortgage amount ($5 million) over basis ($1 million). <u>In other words, the admission of new partners who are willing to pay for rehabilitation would have the effect of charging the existing owners with tax liability on $2 million of paper "gain"</u>.

As the president of a trade association of industry professionals that has confronted this problem, I know that there is no easy way out of this dilemma. For example, structuring the transaction so that the original owners are bought out entirely does not avoid the consequences of the allocation rules. In such a case, the added tax liability that the original owners will face as a result of sale will have to be taken into account in the purchase price. <u>Thus, in either case, a substantial portion of the value of the low income housing tax credit is eaten up not by the rehabilitation of low-income housing, but in solving the tax liability problems of existing owners.</u>

We can see the further consequences of the situation by returning to the investor's side. Assuming a $6 million rehabilitation basis and a 9% credit, the project would generate $5.4 million in tax credits over the ten-year credit period. Of this, the new investors would be entitled to $2.7 million, on the basis of their 50% ownership share. If we assume that investors are willing to pay fifty cents on the dollar, they will be willing to invest $1.35 million for this credit. Thus, $5.4 million in credit generates only $1.35 million in cash. Of course, the remainder of the credit would go to the existing owners and could, theoretically, offset a portion of their additional tax liability as a result of the entry of new investors. This offset only occurs in the first year, however, and in subsequent years the additional credit generated may be unusable to the initial investors who would very likely be caught by the passive loss rule.

In summary, the allocation of ownership shares between new and existing investors, and the allocation of the credit in accordance with those shares, creates significant tax problems

for the existing owners and substantially reduces the efficiency of the credit for the new owners.

<u>A Proposed Solution</u>.

A simple solution can be found by making a technical amendment to the tax credit provisions (Section 42 of the Internal Revenue Code of 1986, as amended) to permit allocations of credit among partners in a rehabilitation project to be made in a manner consistent with the thrust of Section 42(e) of the Code. In other words, if rehabilitation is now treated as a "new building" for purposes of qualifying for and receiving the low income credit housing tax credit, it might also be treated as a "new building" for purposes of ownership and allocation of profits, losses and tax credits.

If this rule were applied in the situation described above, the existing owners would continue to own 100% of the existing structure, while the new investors would own 100% of the "new building" created by rehabilitation. The old investors and new investors would be deemed to form a kind of joint venture for tax purposes, to which each group would contribute its own interest in the project. The new investors would belong to a new partnership for tax purposes, and the credit would be determined and allocated at the new partnership level rather than at the joint venture level.

Note that in order to effect this change in tax treatment, the "venture" need not qualify as a joint venture for state law purposes, nor should it be necessary to form a second partnership for the new investors or transfer record title to the property. Rather, the joint venture would merely be a tax construct.

A tax rule that recognizes the joint venture structure for tax purposes would permit the new investors to be allocated the entire credit attributable to the "new property", while preventing the existing owners from experiencing dilution in basis or recapture. Cash flow, profits and losses from the rental units, as well as profits from the eventual sale of the project, would be allocated in accordance with the economic agreement of the parties that would presumably be based, in large part, on the portion of the total project "contributed" by each group of investors. Conforming changes would also need to be made to section 752 of the Internal Revenue Code, to provide appropriate treatment for secondary financing and refinancing.

* * * *

In enacting the low-income housing tax credit in 1986 Congress recognized that low-income housing is a continuing federal responsibility, that low income housing cannot attract investors solely on the basis of cash flow and capital appreciation, and thus, that some tax incentives to investors are necessary if this responsibility is to be effectuated. Moreover, in designing this credit Congress specifically intended that the costs of acquiring, constructing and <u>rehabilitating</u> housing constitute the eligible basis for this credit.

It is apparent that current IRS rules for allocating the tax credit in the case of the rehabilitation of previously syndicated rental housing are frustrating Congress's intended purpose in enacting the low income housing tax credit. I am pleased that President Clinton has proposed a permanent extension of the Low-Income Housing Tax Credit, and we at NAHMA regard this as an important core provision of the President's economic program. The credit is one of the many tools necessary to encourage the development of decent, affordable housing. At the same time, I urge this Committee to enact technical improvements to the Low-Income Housing Tax Credit provisions to enable the full benefit

of the credit to reach rehabilitation projects as well. The change will enhance our ability to maintain and preserve housing that currently meets the housing needs of low income Americans. NAHMA welcomes the opportunity to work with you on this important matter.

Mr. PAYNE. Mr. Grogan.

STATEMENT OF PAUL S. GROGAN, PRESIDENT, LOCAL INITIATIVES SUPPORT CORP., NEW YORK, NY

Mr. GROGAN. Thank you, Mr. Chairman.

Like Mr. Harvey of the Enterprise Foundation, I have had the annual privilege since 1989 of appearing before this committee. And as much fun as it has been, I think we both would forego that privilege in exchange for a permanent extension of the low-income housing tax credit. So let me join him in requesting that that be the action taken.

There has been an important change this year, of course, and that is for the first time we find ourselves in the happy situation of endorsing the executive branch's program. I think, by his inclusion of a permanent extension to the tax credit in the overall economic program, President Clinton has shifted the calculus enormously. We are grateful to him and we think it is a very wise decision for him to have made that proposal.

Let me say a word about our organization. I am the president of something called the Local Initiatives Support Corp., which is a charitable purpose, nonprofit organization founded by the Ford Foundation 13 years ago to assist grassroots community development corporations in reviving their communities by providing technical and organizational help and private sector financial assistance. We, like the Enterprise Foundation, are a major user of the low-income housing tax credit.

We have persuaded 100 Fortune 500 companies to invest $625 million in the financing of about 14,000 units of housing in 53 cities and 20 States across the country. So that very substantial scope of experience coast to coast has equipped us, I think, to make sober judgments about the merits of this program.

I have to admit that at the time this program was enacted, it was widely regarded by ourselves and many others as an improvisation at a period when the Federal Government, to put it mildly, was hardly in the business of exploring new solutions in an active way to the problem of affordable housing. We felt it was the best we could get under the circumstances.

However, in hindsight, this program has proved to be far better than even its framers, and we were among those, could have hoped. In fact, I venture to say this is the best Federal low-income housing program in the history of this country. I would focus on three of its principal benefits, along with the many others that have already been cited by my predecessor panelists.

First, the flexibility of the program. Community groups in all 50 States and for-profit developers have been able to use this credit to finance a dizzying variety of housing that is locally determined and locally appropriate: single-room occupancy hotels for the homeless, new townhouses for families, the renovation of abandoned apartment buildings in the large cities like Philadelphia and New York, and scattered single-family homes.

All of these are able to be assisted by the tax credits and no Federal bureaucracy has to be consulted about what particular kind of housing is built with the credit. This has unleashed a flood of local innovation.

Second, the localization of the decisionmaking about how the credit is to be used. While no program is utterly impervious to abuse, I think this is much less likely to be abused than almost any other Federal housing program you can imagine because the allocation of the credit is performed by State housing agencies, which have considerable housing expertise and capacity that has been built enormously in the last few years. Moreover, State agencies are locally situated and best able to make the judgments about the most meritorious housing projects and the other support and financing that are going into the housing.

That is clearly in line with the trend of new federalism to use the capacities of States and localities to make more and more decisions.

Finally, the private sector involvement. This program rather than directly appropriating tax dollars seeks to steer private investment. This is viewed as a disadvantage by some. I think they are incorrect.

In addition to the market discipline mentioned by Mr. Harvey, the program brings Fortune 500 companies into direct contact with the most distressed communities in this country.

We are searching for new ways, and I applaud that we are, with enterprise zones and community development banks, to break down the isolation of low-income communities and to induce private sector investment in them. The low-income housing tax credit is already doing that in a rather spectacular way. The credit instills market discipline, but also results in firsthand contact and exposure. Many of the investing companies involved in our program have been led to undertake other initiatives as a consequence of their long-term high-risk investment in these neighborhoods.

Finally, this program has won for itself a really remarkable constituency. We have appended to our testimony a letter from 800 community-based organizations from all 50 States beseeching this committee and the administration for a permanent extension of the low-income housing tax credit.

In addition, over the last several years, more than 30 major metropolitan newspapers have endorsed, most of them repeatedly endorsed, this program and called for a permanent extension. No other housing program in this country, indeed few other Federal programs of any kind, have won that kind of approbation, and it is simply because these editorial boards have seen firsthand the results in their communities.

So I would say while I too am in favor of a number of the changes that have been proposed by my fellow panelists, a program working this well should be tinkered with probably only slightly, and any proposed changes should be approached with great caution and restraint. It would be far better to make no changes and enact a permanent extension than to make too many and risk arresting what has been really a remarkable performance.

Thank you very much, Mr. Chairman.

[The prepared statement follows:]

Testimony of

Paul S. Grogan
President
Local Initiatives Support Corporation

Good morning, Mr. Chairman. My name is Paul Grogan. I am President of the Local Initiatives Support Corporation (LISC). I am here today to urge the Committee's support for a permanent extension of the Low Income Housing Tax Credit, an element of the President's economic plan and a vital program for the country. We greet with enthusiasm the President's and the Congress' common commitment to community renewal and to programs like the Credit, HOME, and Community Development Block Grants.

As you are well aware, the Credit is the federal government's primary tool for producing sorely needed low-income rental housing. The Credit has produced over 500,000 units since 1987. It now produces about 110,000 units annually, about one-third of all multifamily housing starts, and virtually all of the new multifamily housing affordable to families earning under $18,000.

As important as the Credit is to housing and to the development of healthy communities, it is also important to the economy. The Credit generates an estimated 90,000 jobs, $15 billion of economic activity, and $1.1 billion in state, local, and federal tax revenues. In today's climate, a crucial issue is preventing major drops in employment, economic activity, and housing construction. We have been without the Credit since last June. The longer this pipeline is turned off, the longer it will take to reactivate once the Credit is extended.

Beyond reinstating the Credit, we urge you to establish the program on a permanent basis this year. The annual process of short term extensions has hindered program efficiency because participants are unwilling to get involved in a program with no certain future. A permanent extension would encourage new participants, and the increased competition for the finite pool of Credits would increase efficiency.

About LISC and the National Equity Fund

LISC is the nation's largest CDC support organization. Founded 13 years ago by the Ford Foundation and others, LISC and our affiliates have raised nearly $1 billion, virtually all from the private sector, and used these resources to help 900 CDCs expand their capacity and develop housing and other community development projects in distressed inner-city neighborhoods. These projects have involved 45,000 units of affordable housing.

LISC's National Equity Fund subsidiary has become the nation's largest syndicator of the tax credit, and the largest single source of equity investment capital for CDCs. Since 1987, LISC has raised $620 million from 100 corporations to help CDCs develop 14,000 units valued at close to $1.2 billion. We have raised over $350 million the last two years alone.

We believe that the projects CDCs undertake are among the most difficult and publicly beneficial, because they: (1) are located in distressed inner city neighborhoods; (2) are sponsored by nonprofit groups, which have community boards but limited financial depth; (3) often serve families with acute housing needs that cannot otherwise be met,

including the homeless and single-parent families; (4) keep the housing permanently affordable; and (5) often involve risky rehabilitation of buildings that are crucial to the neighborhood. Obviously, we have to gear our investment policies very flexibly to accommodate these kinds of projects. Nevertheless, we have not suffered a single default.

This track record is attributable to three primary factors.

- First, the nonprofit CDCs know their communities and their residents, and have a real commitment to making their projects work. CDCs develop housing as part of an overall neighborhood strategy; projects are built and managed to last; the entire community gets involved; and tenants have access to other support services. Moreover, CDCs are not going to walk away from a project. They live in the community and are accountable to the community. They cannot just pack up if a project gets in trouble and go somewhere else. They have to stay and make it work. An important way to reinforce the Credit's role in community revitalization would be to allow credits to be used for community service space, such as child care centers, that serve low-income families.

- Second, we underwrite projects very carefully. In almost every case, we already know the CDC sponsor and its neighborhood. We spend a great deal of time on each project. If something is wrong with a proposed project, we can usually discover and correct it before deciding to proceed.

- Third, state or local governments provide direct subsidies, usually in the form of low-interest loans, to almost every project. That money is flexible, and it makes the project work financially. And the active involvement of a city or state can be invaluable to moving projects ahead and overcoming problems as they arise.

Why the Credit Is Good Federal Policy

The success of the Low Income Housing Tax Credit has exceeded almost everyone's early expectations. When initially enacted, there was widespread skepticism about whether developers, investors, and others would be willing to participate in the program. The program was complex, the post-Tax Reform investment climate was chilly, and there were no federal rent subsidies or even regulations. But despite these very real obstacles, the Credit got off to the fastest start of any federal low-income housing program in history. And it has become a stronger program each year.

We ourselves were initially ambivalent in 1985 as the tax reform debates began. It was true that tax incentives to encourage equity investment had been an essential part of federal housing policy since the 1960s, and the only realistic way to attract such investment. And, with direct federal spending greatly reduced, tax incentives were almost the only remaining source of federal support. But, as a charitable, public purpose organization, LISC believed the old incentives were insufficiently targeted to serving low-income people and communities. We also knew that many federal programs had become too complicated and rigid to respond to local needs. Finally, we questioned whether the tax code was the right vehicle for advancing federal low-income housing policy.

Mr. Chairman, the Credit has laid all these questions to rest, and has taught us some important lessons we never anticipated when it was enacted in 1986. In retrospect, the Credit should be seen as the first building block in a more responsive and effective federal low-income housing policy. Many of its best features are reflected in the housing bill enacted in 1990. The Credit is good public policy for many reasons.

- First, the Credit serves genuinely low-income families. Credits are awarded only for low-income units. The housing must generally serve low-income

people for 30 years. Significantly, the Credit is the only current federal housing production program that pays based on actual performance. If the housing does not actually serve low-income tenants for at least 15 years, the federal government gets its money back, and the IRS knows where to find it.

- Second, the Credit is flexible. It helps traditional apartment buildings, single-room occupancy hotels, townhouses, and even single family homes. It works in the inner city and in rural areas. It supports new construction, substantial rehabilitation, and moderate rehabilitation. It works for CDCs and profit-motivated developers alike. While the program is both rigorous and complex, its essential flexibility is a fundamental strength.

- Third, the Credit is cost-effective. I recognize that some have questioned whether this is indeed the case, considering that roughly 45 to 50 cents is invested in the housing at the start of a project for each dollar of Credits paid out over a ten-year period. One part of the answer lies in the time value of money. In fact, the present value of that dollar of Credit spread over ten years is actually about 61 cents. So the 45 to 50 cents invested up front is about 73 to 83 percent of the present value of the federal investment, a ratio we consider good. A second part of the answer is that the housing generally serves low-income people for 30 years, and in no case less than 15 years. As I noted earlier, the federal government gets its money back if the housing stops serving low-income people before this time. Seen as a long-term investment, the Credit is tremendously cost-effective. Let me add that, as you know, the states now analyze each project to ensure that it receives only as much Credit as necessary for financial feasibility and stability. Third, we should recognize that no government program -- whether it involves tax incentives or direct spending -- can ever attain 100 percent cost-effectiveness; there is always a cost of doing business with the government. This is not a criticism, but rather a recognition of reality. So any realistic analysis is of the cost-effectiveness would have to compare the Credit with other federal housing production programs.

  The best way to make the Credit more cost-effective is to extend it permanently. A permanent extension would instill more confidence in the program, encouraging investors to invest more equity for each dollar of Credits. Investors' uncertainty about the future of the Credit is the single greatest impediment to greater efficiency.

- Fourth, the state agencies have done an excellent job with the program. Starting from scratch in 1987, the states have been crucial to making the Credit work so well. Now that the states have allocation plans and monitor project compliance, their role has become even more important. Because the Credit is administered primarily at the state level, the program has been responsive to local needs and accessible to community groups and other participants who are unable to travel regularly to Washington, and processing of applications has generally been timely. The states' fine performance has not only made the Credit work well, but has also shown that other federal housing resources can operate very well through states and localities.

- Fifth, the Credit has engaged some of America's most prominent companies in addressing the low-income housing crisis, and given them for the first time a very real stake in the future of our inner cities. I am sure you can understand the skepticism with which corporations initially greeted the Credit: (1) the program was new and untested; (2) the federal government had just unilaterally revoked real estate related tax benefits that investors had counted on receiving; (3) the public image of low-income housing has generally been negative; (4) the projects would be located in some of the toughest neighborhoods anywhere, many of them plagued by drugs, crime, and disinvestment; (5) in addition to the tax benefits, corporate investors would

receive only enough cash at the end of the process to pay their exit taxes, so that the CDCs could buy the projects and maintain low-income use; and (6) most important, the success of the projects both as housing and as an investment depends on the capability and staying power of the community groups that develop and operate them.

What is truly remarkable is the way corporations have warmed up to the Credit. Many of this country's most respected companies are among the 100 investors we have worked with, a list of which is attached. The Credit has succeeded in tapping a real and deep interest of corporate leaders in getting involved in the issues of low-income housing and neighborhood stabilization. What was missing was a way to get involved within the constraints of a profit motivated business -- in short, a way to do good while doing well. Our investors take these projects seriously. We never could have raised more than $600 million in grants from corporations in five years. We all talk about how important it is to engage the corporate sector in solving social problems. The Credit proves it can be done and shows us how. The primary obstacle to their greater involvement is the uncertainty created by each year's struggle to keep the Credit alive. A permanent extension would make a big difference.

- Sixth, the Credit has encouraged cities and states to devote their own resources to low-income housing. As you may know, the Credit alone is usually insufficient to make a project financially feasible with affordable rents; some other source of the public subsidy is required. At a time when direct federal spending for housing is so limited, the Credit has proved a powerful stimulus for unleashing an array of state and local resources -- including land and buildings they own, dedication of Community Development Block Grants (CBDG), HOME, and other federal resources at their disposal, tax abatements, and direct spending of local general revenues. California has even created its own low-income housing tax credits. It is important that Congress encourage this participation as strongly as possible. As you know, CDBG funds do not reduce the Credit when they are used as below-market loans. We urge you to permit the same treatment for funds appropriated under the new HOME program created in 1990 as part of the Cranston-Gonzalez National Affordable Housing Act.

  Another important change -- not even a part of the tax code -- would be to enable community groups to more easily access Section 8 existing housing rental assistance so that they can serve the community's lowest income residents more effectively. We believe that Section 8 existing rental assistance is a good vehicle for ensuring that the lowest income families can be served and agree that certificate and voucher holders absolutely should not be victims of discrimination.

- Seventh, the Credit has given CDCs an important resource to bring to the public/private/community partnership process. A true partnership requires each partner to bring something to the table. Through LISC's NEF, a CDC can approach lenders and city officials with substantial investment capital at its disposal. We find that this resource enhances the partnership process greatly.

- Eighth, the involvement of private investors provides valuable underwriting rigor that greatly strengthens the housing and its long-term sustainability. The investors will not participate unless convinced they will receive a reasonable rate of return, which depends primarily on whether projects can be completed and low-income occupancy maintained as planned. Without the Credit, there would be no private investors to instill this underwriting rigor.

- Ninth, Credit projects generally involve a more sensible mix of equity and debt than had been the case under the old Section 8 production programs. Under

these programs, which were phased out a decade ago, artificially high subsidized rents were used to support mortgages that in many cases exceeded the value of the property. If a serious problem emerged, an owner could have little to lose by walking away. With the Credit however, more equity can generally be raised but a smaller mortgage supported. Without rent subsidies, a first mortgage from a bank cannot exceed the property's value. Because of the Credit, the owner will usually have a larger equity stake to protect if a project gets in trouble and stands to suffer substantial recapture of the Credits if a project fails. This incentive structure makes good policy sense.

- Tenth, the Credit has drawn a degree of support unprecedented for a federal housing program -- from Congress, the media, states and localities, advocates, and from CDCs and other nonprofits. In the last Congress, 331 members of the House sponsored H.R. 413 to extend the Credit permanently, and 86 Senators sponsored S. 308. The Congress twice approved a permanent extension as part of a larger tax package that President Bush vetoed. This year, Chairman Rostenkowski has already introduced a permanent extension bill (H.R 18).

  The Credit has attracted favorable editorials in over 30 major metropolitan newspapers, and has been featured on television news programs. For example, NBC Nightly News and the MacNeil-Lehrer News Hour both have featured CDCs using the Credit in a way that rebuilds communities, rebuilds lives, and rebuilds our national confidence that social programs can work.

  As further testimony to the breadth of support for this program, I have attached a letter to Chairman Rostenkowski signed by more than 800 nonprofit community groups based in communities coast to coast urging a permanent extension to the Credit.

  We believe it is important that government programs earn the support and confidence of the general public. The Credit is so popular because it meets a real need, involves a wide range of partners (including community groups, the private sector, and government at all levels), and, most important, it works.

In conclusion, Mr. Chairman, let me thank you, Congressman Rangel, the other members of the Committee and your staffs for your support of the Credit. We believe that this is one program that has worked, is working, and without major deliberation could be put back on line quickly, pumping construction dollars into the economy and making a difference in the lives of our neighborhoods from South Central Los Angeles to the South Bronx. We believe the program's performance has earned a permanent extension.

National Equity Fund
Corporate Investors 1987 - 1992

Aetna Life & Casualty
American Express Company
Ameritech
Arco
Astoria Federal Savings & Loan
AT&T
Avery Dennison Corporation
Banc One Corporation
Bank of America NT & SA
Bank of New England
Bank of New York
Bankers Trust New York Corporation
Bear Stearns Companies, Inc.
Berkshire Hathaway, Inc.
Boatman's Bank
The Boeing Company
Bristol-Myers Squibb Company
The Brooklyn Union Gas Company
California Federal Savings & Loan
Canadian Imperial Bank of Commerce
Capital Cities/ABC, Inc.
CBS, Inc.
Chemical Bank
Chevron Corporation
Citicorp
City National Bank
Consolidated Edison Company of NY, Inc.
The Continental Corporation
Dime Savings Bank of
New York, FSB
Dominion Capital, Inc.
Eastman Kodak Company
East River Savings Bank, a Division of River Bank America
Eli Lilly & Company
Equitable Financial Companies
Fannie Mae
First Bank System
Freddie Mac
First Federal Savings Bank of California
First Interstate Bank
First Nationwide Bank
First of America CDC
Fleet Bank
Glendale Federal Savings
Great Western Financial Corp.
H & R BlockHallmark Cards, Inc.
Home Savings of America
Honeywell, Inc.
INB Financial Corporation
J.C. Penney Company, Inc.
J.P. Morgan & Co., Inc.
Kansas City Life Insurance Company
Kansas City Power & Light
Kaufman & Broad Home Corporation
Knight-Ridder, Inc.
KTLA, Inc.
Levi Strauss & Company
Manhattan Savings Bank
Mellon Bank, NA
Melville Corporation
Meridian Bank, NA
Midlantic Corporation
National Westminster Bank USA
New York Life Insurance Company
New York Telephone Company
Northern States Power Company
Norwest Investment Services
Payless Cashways, Inc.
Pfizer Inc.
Piper Jaffray Companies, Inc.
Provident National Bank
The Prudential Insurance Company of America
Quantum Chemical Corporation
Republic National Bank of New York
Safra National Bank
The St. Paul Companies, Inc.
Saloman Bros., Inc.
Security Pacific National Bank
Signet Banking Corporation
Society Corporation
The Stanley Works
Transamerica
TW Services, Inc.
Walt Disney (Buena Vista TV)
Wells Fargo Bank & Company
Westamerica Bancorp
Weyerhauser Company
Woolworth Corporation
Xerox Corporation

TOTAL INVESTORS: 100

Cities With National Equity Fund Projects

Berkeley, CA
Boston, MA
Camden, NJ
Chicago, IL
Chula Vista, CA
Cincinnati, OH
Cleveland, OH
Coachella, CA
Detroit, MI
Durham, NC
Escondido, CA
Evanston, IL
Fresno, CA
Grand Rapids, MI
Hartford, CT
Healdsburg, CA
Hollywood, CA
Indianapolis, IN
Issaquah, WA
Jersey City, NJ
Kalamazoo, MI
Kansas City, MO
Lansing, MI
Los Angeles, CA
Miami, FL
Minneapolis, MN
New Britain, CT
Newark, NJ
New York, NY
Oakland, CA
Omaha, NE
Pasadena, CA
Petaluma, CA
Philadelphia, PA
Pittsburgh, PA
Portland, OR
Providence, RI
Raleigh, NC
Richmond, VA
St. Helena, CA
St. Louis, MO
St. Paul, MN
Salem, MA
San Diego, CA
San Francisco, CA
Santa Monica, CA
Seattle, WA
South Bend, IN
Stockton, CA
Tacoma, WA
Toledo, OH
Washington, DC
West Hollywood, CA

Total Cities: 53
Total States: 20

February 25, 1993

The Honorable
Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
2111 Rayburn House Office Bldg.
Washington, DC 20515

Dear Mr. Chairman:

The more than 800 undersigned community-based housing organizations from throughout the country thank you for your support of a permanent extension for the Low Income Housing Tax Credit. We urge you to continue working within the Congress and with President Clinton to achieve an immediate extension of this program.

The Credit is this nation's primary tool for building the affordable rental housing sorely needed in communities across the nation. The Credit has produced over 500,000 homes since 1987. It works in urban and rural communities to rehabilitate and construct affordable apartments, single-family homes, and specially designed housing for the homeless and other special needs populations. It now produces about 110,000 affordable housing units annually, about one-third of all multifamily housing starts, and virtually all of the new multifamily housing affordable to families earning under $18,000.

The Credit is also important to the economy. An immediate extension is urgently needed to preserve the estimated 90,000 jobs, $15 billion of economic activity, and $1.1 billion in state, local, and federal tax revenues that the Credit generates annually. A full year of activity could be lost unless the Credit is extended early enough to keep the pipeline of housing flowing. A major issue today is preventing a major drop in employment, economic activity, and housing construction at a crucial time for communities and the nation. The longer this pipeline is turned off, the longer it will take to reactivate once the Credit is extended.

This time, the Credit should be extended permanently. The annual process of short-term extensions has hindered program efficiency because participants are unable to rely on the Credit as a dependable resource they can plan to use over the long term. Many prospective investors and sponsors are unwilling to get involved in a program with no certain future. A permanent extension would encourage new participants and the increased competition for the finite pool of Credits would increase efficiency.

We know from our experience working at the grassroots level that progress in overcoming this country's severe shortage of decent, affordable housing requires the kinds of creative solutions and especially the private sector involvement that the Credit has stimulated. The Credit has generated not just shelter, but also new collaborations among corporate and individual investors, community organizations, state and local governments, and lenders. These promising and effective approaches can only be sustained and expanded if the Credit receives the status it deserves as a permanent part of the tax code.

On behalf of the millions of Americans without decent, affordable homes, we are deeply grateful for your support and leadership for permanent extension of the Low Income Housing Tax Credit.

Sincerely,

Undersigned Community-Based Housing Organizations

Anchorage Neighborhood Housing Services, Inc.	Anchorage	AK
Neighborhood Services, Inc.	Birmingham	AL
Community Action Agency of N. Central Alabama	Decatur	AL
Federation of Southern Cooperatives, Land Asst. Fund	Epes	AL
PLBA Housing Dev. Corp.	Gainesville	AL
Wil-Low Nonprofit Housing Corporation, Inc.	Hayneville	AL
Mobile Community Action, Inc.	Prichard	AL
Community Service Programs of West Alabama	Tuscaloosa	AL
Southern Development Bancorporation	Arkadelphia	AR
Arkansas Land and Farm Development Corp.	Brinkley	AR
Arkansas Assoc. of Community Development Corps.	Pine Bluff	AR
Good Faith Fund	Pine Bluff	AR
Southeast Arkansas Community Development Corp.	Pine Bluff	AR
The National Center for American Indian Enterprise Dev.	Mesa	AZ
Chicanos Por La Causa, Inc.	Phoenix	AZ
Urban Coalition West	Phoenix	AZ
Salt River Pima-Maricopa Indian Community	Scottsdale	AZ
A. Phillip Randolph Community Dev. Corp.	Bakersfield	CA
Kern Minority Contractors Assoc.	Bakersfield	CA
Berkeley Oakland Support Services	Berkeley	CA
L. A. Housing, Inc.	Berkeley	CA
Resources for Community Development	Berkeley	CA
Mercy Family Housing California	Burlingams	CA
Calexica Community Action Council	Calexica	CA
South Bay Community Services	Chula Vista	CA
Community Services Unlimited, Inc.	Compton	CA
Shelter, Inc.	Concord	CA
Council of Churches of Santa Clara County	Cupertino	CA
Community Housing Opportunities Corp.	Davis	CA
Community Development Institute	E. Palo Alto	CA
Mead Housing, Inc.	El Segundo	CA
North County Housing Assoc.	Escondido	CA
South County Housing	Gilroy	CA
Eden Housing, Inc.	Hayward	CA
Eden Council for Hope and Opportunity	Hayward	CA
Coachella Valley Housing Coalition	Indio	CA
United Cambodian Community, Inc.	Long Beach	CA
A Community of Friends	Los Angeles	CA
Breesee Institute	Los Angeles	CA
Catholic Charities Community Dev. Corp.	Los Angeles	CA
Community & Human Resources, Inc.	Los Angeles	CA
Concerned Citizens of South Central Los Angeles	Los Angeles	CA
Corridor Economic Development Corporation	Los Angeles	CA
Dunbar Economic Development Corp.	Los Angeles	CA
Esperanza Community Housing Corp.	Los Angeles	CA
Fair Housing Congress of Southern California	Los Angeles	CA
Fame Assistance Corp. - First A.M.E. Church	Los Angeles	CA
Korean American Coalition	Los Angeles	CA
Los Angeles Community Design Center	Los Angeles	CA
Mental Health Association in Los Angeles County	Los Angeles	CA
Nehemiah West Housing Corporation	Los Angeles	CA
Neighborhood Housing Service	Los Angeles	CA
People Assisting the Homeless	Los Angeles	CA
Skid Row Housing Trust	Los Angeles	CA
The Seedling	Los Angeles	CA
The Coalition for Women's Economic Development	Los Angeles	CA
United Community and Housing Dev. Corp.	Los Angeles	CA
Venice Community Housing Corporation	Los Angeles	CA
Victory Urban Partnership, Inc.	Los Angeles	CA
Watts Health Foundation, Inc.	Los Angeles	CA
Westminster Neighborhood Assoc., Inc.	Los Angeles	CA
Housing Assoc. for Napa Development	Napa	CA
NAPA County Council For Economic Opportunity	Napa	CA
MAAC Project	Nathenal City	CA
California Housing Partnership Corporation	Oakland	CA
East Bay Asian Local Dev. Corp.	Oakland	CA
Jubilee West	Oakland	CA

Lao Family Community Dev. Inc.	Oakland	CA
Oakland Neighborhood Housing Services, Inc.	Oakland	CA
San Antonia Community Dev. Corp	Oakland	CA
St. Mary's Gardens	Oakland	CA
The Agora Group	Oakland	CA
Mid-Peninsula Housing Coalition	Palo Alto	CA
Midpeninsula Citizens for Fair Housing	Palo Alto	CA
Congregational Homes, Inc.	Pamona	CA
All Saints Housing Commission	Pasadena	CA
Pasadena Housing Alliance	Pasadena	CA
Pacific Community Services, Inc.	Pittsburg	CA
Self Help Home Improvement Project	Redding	CA
Lao Mien American Association, Inc.	Richmond	CA
Richmond Neighborhood Housing Services, Inc.	Richmond	CA
Rural California Housing Corp.	Sacramento	CA
Sacramento Neighborhood Housing Services, Inc.	Sacramento	CA
Asian Neighborhood Design	San Francisco	CA
Bridge Housing Corporation	San Francisco	CA
Buen-Dia Family School	San Francisco	CA
California Reinvestment Committee	San Francisco	CA
Central City Hospitality House	San Francisco	CA
Chicano Federation of San Diego County	San Diego	CA
Consumers Union	San Francisco	CA
Episcopal Community Services	San Diego	CA
Grace Baptist Housing, Inc.	San Francisco	CA
Housing Our People Economically CDC	San Diego	CA
Housing Opportunities, Inc.	San Diego	CA
Housing Partners, Inc.	San Bernardino	CA
Innovative Housing	San Rafael	CA
Mary Elizabeth Inn	San Francisco	CA
Mexican-American Community Services Agency, Inc.	San Jose	CA
Misson Housing Development Corp.	San Francisco	CA
Nonprofit Fed. for Housing & Community Dev.	San Diego	CA
Project Home Run	San Bernardino	CA
San Jose Development Corp.	San Jose	CA
San Francisco Housing Development Corp.	San Francisco	CA
San Francisco Renaissance Entrepreneurship Center	San Francisco	CA
Sherman Heights Community Center	San Diego	CA
The Organization for Bus., Education & Comm. Advancement	San Francisco	CA
Trabajadores de la Raza, Inc.	San Ysioro	CA
Community Action Board of Santa Cruz County, Inc.	Santa Cruz	CA
Latino Resource Organization, Inc.	Santa Monica	CA
Santa Barbara Community Housing Corp.	Santa Barbara	CA
Step Up On Second	Santa Monica	CA
Cabrillo Economic Development Corp.	Saticoy	CA
Sonoma County Task Force on the Homeless	Sebestopol	CA
Many Mansions Inc. 501 (c)3	Thousand Oaks	CA
Peoples Center for Housing Change	Topanga	CA
Western Developments for Affordable Housing	Tustin	CA
Tri-CED Community Recycling	Union City	CA
Vallejo Neighborhood Housing Services, Inc.	Vallejo	CA
El Pajaro CDC	Watsonville	CA
Pajarn Valley Affordable Housing Corp	Watsonville	CA
Alternative Living for the Aging	West Hollywood	CA
Queue-Up, Inc	West Hollywood	CA
Colorado Rural Housing Dev. Corp.	Denver	CO
Hope Communities, Inc.	Denver	CO
NEWSED Community Development Corp.	Denver	CO
The Denver Enterprise Center	Denver	CO
Bridgeport Neighborhood Fund, Inc.	Bridgeport	CT
Techni Co-op, Inc.	Bridgeport	CT
Reach, Inc.	Derby	CT
Community Renewal Team of Greater Hartford, Inc.	Hartford	CT
Connecticut Housing Investment, Inc.	Hartford	CT
Hill Housing, Inc.	Hartford	CT

Sheldon Oak Central. Inc.	Hartford	CT
Southside Institutions Neighborhood Alliance	Hartford	CT
Taino Housing & Development Corp.	Hartford	CT
Meri Weather, Inc.	Meriden	CT
Meriden Community Action Agency	Meriden	CT
Conn. Assoc. of Housing Dev. Corp.	New Haven	CT
Eastern Conn. Housing Opportunities, Inc.	New London	CT
Greater New Haven Community Loan Fund	New Haven	CT
Nutmeg Housing Dev. Corp	New Haven	CT
Fairfield County Mutual Housing Assoc.	Norwalk	CT
Norwalk Economic Opportunity Now, Inc.	Norwalk	CT
Fairfield 2000 Homes Corporation	Stamford	CT
Housing Development Fund of Lower Fairfield County, Inc.	Stamford	CT
St. Luke's Community Services. Inc	Stamford	CT
Inner City Community Housing Corp.	Woodbridge	CT
Capitol Hill Group Ministry	Washington	DC
Center City Community Corporation	Washington	DC
Development Corp. of Columbia Heights	Washington	DC
For Love of Children	Washington	DC
Greater Washington Mutual Housing Assoc.	Washington	DC
Hope Housing	Washington	DC
Jubilee Housing, Inc.	Washington	DC
Latino Economic Dev. Corp., Inc.	Washington	DC
Marshall Heights Community Development Org., Inc.	Washington	DC
So Others Might Eat	Washington	DC
The Nehemiah Group	Washington	DC
YACHAD	Washington	DC
Interfaith Housing Delaware	Wilmington	DE
Homes In Partnership, Inc.	Apopka	FL
Coconut Grove Local Development Corp.	Coconut Grove	FL
Centro Campesino Farmworker Center Inc.	Florida City	FL
Lee County Employment & Economic Development Corp.	Fort Meyers	FL
Guadalupe Social Services	Immokalee	FL
Immokalee Non-Profit Housing, Inc.	Immokalee	FL
Springfield Preservation and Restoration (SPAR), Inc.	Jacksonville	FL
Timberleaf Institute	Lakeland	FL
CODEC, Inc.	Miami	FL
Dade Partnership for Community & Economic Development	Miami	FL
East Little Havana CDC	Miami	FL
Greater Miami Neighborhoods	Miami	FL
Haitian Task Force, Inc.	Miami	FL
Hispanic Coalition	Miami	FL
Little Haiti Housing Association	Miami	FL
Miami-Dade Neighborhood Housing Services, Inc.	Miami	FL
New Century Development Corp., Inc.	Miami	FL
St. John Community Development Corp.	Miami	FL
Tools for Change	Miami	FL
Community Equity Investments. Inc.	Pensacola	FL
Capital Area Community Action Agency, Inc.	Tallahassee	FL
Florida Low Income Housing Coalition	Tallahassee	FL
Palm Beach County Housing Partnership, Inc.	West Palm Beach	FL
Atlanta Neighborhood Development Partnership, Inc.	Atlanta	GA
Atlanta Housing Assoc. Of Neighborhood-based Developers	Atlanta	GA
Mad Housers	Atlanta	GA
Pittsburgh Partnership, Inc.	Atlanta	GA
Progressive Redevelopment, Inc.	Atlanta	GA
Reynoldstown Revitalization Corporation	Atlanta	GA
SUMMECH Community Land Trust	Atlanta	GA
University Community Development Corp.	Atlanta	GA
Vine City Housing Ministry	Atlanta	GA
Housing Opportunity, Inc.	Gainesville	GA
Friendship Ministry, Inc.	Macon	GA
Nehemiah Housing Corp.	Middletown	GA
Tift County Residential Housing Corp.	Tifton	GA
Hina-malailena	Hana	HI

Self-Help Housing Corporation of Hawaii	Honolulu	HI
Boise Neighborhood Housing Services, Inc.	Boise	ID
Joseph Corporation of Illinois, Inc.	Aurora	IL
Back of the Yards Neighborhood Council	Chicago	IL
Beverly Area Local Development Company	Chicago	IL
Chicago Roseland Coalition for Community Control	Chicago	IL
City Lands Corporation	Chicago	IL
Community & Economic Dev. Association of Cook County, Inc.	Chicago	IL
Community Economic Development Law Project	Chicago	IL
Edgewater Development Corp.	Chicago	IL
Eighteenth Street Dev. Corp.	Chicago	IL
Howard/Paulina Development Corp.	Chicago	IL
Jane Addams Resource Corp.	Chicago	IL
Kenwood Oakland Community Organization	Chicago	IL
Kinzie Industrial Development Corp.	Chicago	IL
Lakefront SRO Corporation	Chicago	IL
Lawndale Christian Dev. Corp.	Chicago	IL
Lawrence Avenue Development Corp.	Chicago	IL
National Equity Fund	Chicago	IL
NHS Redevelopment Corp.	Chicago	IL
North River Commission	Chicago	IL
Northwest Austin Council	Chicago	IL
Residents Development Corporation	Chicago	IL
Southwest Chicago Development Commission	Chicago	IL
Statewide Housing Action Coalition	Chicago	IL
The Neighborhood Institute	Chicago	IL
Travelers & Immigrants Aid of Chicago	Chicago	IL
Uptown Center Hull House Association	Chicago	IL
Voice of the People in Uptown, Inc.	Chicago	IL
Woodstock Institute	Chicago	IL
Carver Community Action Agency	Galesburg	IL
New Cities Community Dev. Corp	Harvey	IL
Kankakee Community Dev. Corp.	Kankakee	IL
Shawnee Dev. Council, Inc.	Karnak	IL
Western Illinois Regional Council - Community Action Agency	Macomb	IL
Reach Menders, Inc.	Rock Island	IL
Trinity House, Inc.	Rockford	IL
Bridge Communities	Wheaton	IL
Urban League of Madison County, Inc.	Anderson	IN
Middle Way House	Bloomington	IN
Human Needs Council of Bartholomew County	Columbus	IN
Community Action Program Inc. of Western Indiana	Covington	IN
Community Reinvestment Project of East Chicago, Inc.	East Chicago	IN
Fort Wayne Neighborhood Housing Partnership	Fort Wayne	IN
Housing & Neighborhood Dev. Services, Inc.	Fort Wayne	IN
Tree of Life Community Development Corporation	Gary	IN
LaCasa of Goshen, Inc.	Goshen	IN
Opportunity Housing, Inc. of Putnam County	Greencastle	IN
Community Center Dev. Corp.	Hammond	IN
Maywood Community Dev. Corp.	Hammond	IN
Northwest Indiana Community Reinvestment Alliance	Hammond	IN
Central Indiana Council on Aging	Indianapolis	IN
Dayspring Center	Indianapolis	IN
Eastside Community Investments, Inc.	Indianapolis	IN
Fountain Square Church & Community Project	Indianapolis	IN
Indiana Urban Enterprise Assoc., Inc.	Indianapolis	IN
Indiana Alliance for the Mentally Ill, Inc.	Indianapolis	IN
Indianapolis Neighborhood Housing Partnership	Indianapolis	IN
Indianapolis Resource Ctr. For Independent Living	Indianapolis	IN
King Park Area Development Corporation	Indianapolis	IN
Mapleton-Fall Creek Housing Development Corp	Indianapolis	IN
Martin Luther King Community Dev. Corp.	Indianapolis	IN
Martindale -Brightwood Community Dev. Corp	Indianapolis	IN
Respectful Labor A Plus	Indianapolis	IN
Riley Firea Revitalization Program	Indianapolis	IN
Starke County Development Foundation, Inc.	Knox	IN
AZUSA Community Development Corp. of Indiana	Kokomo	IN

Harvest Homes, Inc.	Kokomo	IN
Horizon Housing Community Development Corp.	Michigan City	IN
Old Westend Neighborhood Economic Redevelopment Corp.	Muncie	IN
Open Door Community Services, Inc.	Muncie	IN
Safety Zone, Inc.	Munsey	IN
Jasper County Industrial Foundation	Rensselaer	IN
Institute for Social Economic Development	Iowa City	IO
Partridge Comm. Assoc. Housing Committee	Hutchinson	KS
Kansas City West Side Housing Organization	Kansas City	KS
Cornerstone of Topeka, Inc.	Topeka	KS
Housing and Credit Counseling, Inc.	Topeka	KS
Stardusters Crime Prevention, Inc.	Topeka	KS
Mennonite Housing Rehabilitation Services, Inc.	Wichita	KS
Mountain Assoc. for Community Econ. Development	Berea	KY
Kentucky Housing Corporation	Frankfort	KY
Community Action Council	Lexington	KY
Louisville Economic Opportunity Corp.	Louisville	KY
Louisville Urban League	Louisville	KY
New Directions Housing Corp.	Louisville	KY
The Housing Partnership, Inc.	Louisville	KY
Frontier Housing, Inc.	Morehead	KY
Bethany House Christian Service Center/KEYS Housing	Olive Hill	KY
Kentucky Appalachin Ministry	Richmond	KY
People's Self-Help Housing, Inc.	Vanceburg	KY
Christopher Homes, Inc.	New Orleans	LA
Desire Community Housing Corporation	New Orleans	LA
New Orleans Neighborhood Development Foundation	New Orleans	LA
Third Shiloh Missionary Baptist Church	New Orleans	LA
Allston Brighton CDC	Allston	MA
Millers River Self-Help Network CDC	Amhurst	MA
Boston Aging Concerns	Boston	MA
Castle Square Tenants Organization	Boston	MA
Dorchester Bay Economic Development Corp.	Boston	MA
Fenway Community Development Corp.	Boston	MA
Inquilinos Boricuas En Accion (IBA)	Boston	MA
Massachusetts Community Econ. Dev. Asst. Corp.	Boston	MA
Massachusetts Assoc. of Community Development Corps.	Boston	MA
Metropolitan Boston Housing Partnership	Boston	MA
Tent City Corporation	Boston	MA
The Philadelphia Initiative, Inc.	Boston	MA
Cambridge Neighborhood Apartment Housing Services, Inc.	Cambridge	MA
Homeowner's Rehab, Inc.	Cambridge	MA
Just-A-Start Corp.	Cambridge	MA
Cambodian Community of Massachusetts, Inc.	Chelsea	MA
Chicopee Development Corpration	Chicopee	MA
Codman Square Housing Dev. Corp.	Dorchester	MA
Dorchester Bay Economic Dev. Corp.	Dorchester	MA
Lena Park Community Dev. Corp.	Dorchester	MA
East Boston Community Development Corp.	East Boston	MA
Neighborhood of Affordable Housing	East Boston	MA
CDC of Fitchburg	Fitchburg	MA
South Middlesex Opportunity Council, Inc.	Framingham	MA
Greater Gardner CDC	Gardner	MA
Community Action, Inc.	Hausehill	MA
Neuva Esperanza, Inc.	Holyoke	MA
The Neighborhood Dev. Corp. of Jamaica Plain	Jamaica Plain	MA
New Bedford Women's Center	New Bedford	MA
Madison Park Development Corp.	Roxbury	MA
Quincy Geneva Housing Dev. Corp.	Roxbury	MA
Urban Edge Housing Corporation	Roxbury	MA
Salem Harbor CDC	Salem	MA
Community Action Agency of Somerville	Somerville	MA
Springfield Neighborhood Housing Services, Inc.	Springfield	MA
Valley Community Development Corporation	Springfield	MA
Waltham Alliance to Create Housing, Inc.	Waltham	MA

Green Island Vernon Hill CDC	Worcester	MA
Oak Hill Community Development Corp.	Worcester	MA
Associated Black Charities	Baltimore	MD
Baltimore Urban Leadership Foundation	Baltimore	MD
Comprehensive Housing Assistance, Inc.	Baltimore	MD
Druid Heights Community Development Corporation	Baltimore	MD
Neighborhood Rental Services of Baltimore, Inc.	Baltimore	MD
Neighborhood Housing Services of Baltimore, Inc.	Baltimore	MD
Neighborhood Housing Services of Irvington	Baltimore	MD
New Song Urban Ministries	Baltimore	MD
Northwest Baltimore Corporation	Baltimore	MD
Sandtown Habitat For Humanity, Inc.	Baltimore	MD
Southeast Development, Inc.	Baltimore	MD
St. Ambrose Housing Aid Center, Inc.	Baltimore	MD
The Loading Dock	Baltimore	MD
The Family Place	Baltimore	MD
Grassroots Crisis Intervention Center, Inc.	Columbia	MD
Interfaith Housing Development Corp.-Maryland Eastern Shore	Denton	MD
Ellicott City Restoration Foundation, Inc.	Ellicott City	MD
Western Md. Interfaith Housing Dev. Corp.	Frederick	MD
Religious Effort to Assist and Care for the Homeless	Hagerstown	MD
Tri-County Community Development Corporation, Inc.	Hughesville	MD
Housing Opportunities Commission of Montgomery Co. Md.	Kensington	MD
Build, Inc.	Laurel	MD
Garrett County Community Action Committee, Inc.	Oakland	MD
Cooperative Housing Foundation	Silver Spring	MD
Mankind Research Foundation, Inc	Silver Spring	MD
Housing Ownership Purchase Effort, Inc. of Carroll County	Westminster	MD
Montgomery Housing Partnership, Inc.	Wheaton	MD
Community Concepts, Inc.	Auburn	ME
Neighborhood Action Coalition of Greater Portland	Portland	ME
South Portland Housing Dev. Corp.	S. Portland	ME
Adrian Dominican Sisters' Portfolio Advisory Board	Adrian	MI
Ann Arbor Community Development Corporation	Ann Arbor	MI
Campus Cooperative Development Corporation	Ann Arbor	MI
Mood Awareness Resource NTWK, Inc.	Babbitt	MI
Cornerstone Alliance	Benton Harbor	MI
Black Economic Trade Assoc.	Detroit	MI
CASS Corridor Neighborhood Dev. Corp.	Detroit	MI
Church of the Messiah Housing Corporation	Detroit	MI
CORE City Neighborhoods	Detroit	MI
Detroit Non-Profit Housing Corp.	Detroit	MI
Redeemer Community Dev. Corp	Detroit	MI
Weatherization & Retrofit Maint., Inc.	Detroit	MI
Wayne-Metropolitan Community Services Agency	Ecorse	MI
Dwelling Place of Grand Rapids, Inc.	Grand Rapids	MI
Edison Neighborhood Assoc.	Kalamazoo	MI
Kalamazoo Valley Habitat for Humanity	Kalamazoo	MI
Kalamazoo Neighborhood Housing Services	Kalamazoo	MI
Kalamazoo Northside Nonprofit Housing Corp.	Kalamazoo	MI
Van Buren County and Cass County Community Action Agency	Larence	MI
OLHSA	Pontiac	MI
Chippewa-Luce-Mackinac Comm. Act. Human Res. Authority	S. Ste. Marie	MI
Sault Ste. Marie Tribe of Chippewa Indians	S. Ste. Marie	MI
Anoka County Community Action Program, Inc.	Blaine	MN
Midwest Minnesota Community Dev. Corp.	Detroit Lakes	MN
West Bank Community Dev. Corp.	Minneaplois	MN
Artspace Projects, Inc.	Minneapolis	MN
Community Reinvestment Fund	Minneapolis	MN
Family Housing Fund of Minneapolis and Saint Paul	Minneapolis	MN
Minnesota Ctr. For Community Econ. Development	Minneapolis	MN
Phillips Neighborhood Housing Trust	Minneapolis	MN
Project for Pride In Living, Inc.	Minneapolis	MN
East Side Neighborhood Development Co., Inc.	St. Paul	MN
Housing Coalition of the St. Cloud Area, Inc.	St. Cloud	MN
North End Area Revitalization	St. Paul	MN
St. Paul Coalition for Community Dev.	St. Paul	MN

United Way of the St. Paul Area	St. Paul	MN
Westminster Corporation	St. Paul	MN
Goodbye - Rice - Wabasha Citizens Action Council. Inc.	Zumbrota	MN
Blue Hills Homes Corporation	Kansas City	MO
Citizen Housing Information Council	Kansas City	MO
Community Development Corp. of Kansas City	Kansas City	MO
Kansas City Neighborhood Alliance	Kansas City	MO
Mercy Housing Kansas City	Kansas City	MO
New Horizons Assistance Corp.	Kansas City	MO
Old Northwest, Inc.	Kansas City	MO
Catholic Commission on Housing	St. Louis	MO
Community Housing Ministry Inc.	St. Joseph	MO
DeSales Community Housing Corp.	St. Louis	MO
Ecumenical Housing Production Corp.	St. Louis	MO
Hyde Park Alliance	St. Louis	MO
Love-In-Action M.E.T. Ministries	St. Louis	MO
Regional Housing Alliance	St. Louis	MO
St. Louis Transitional Hope House. Inc.	St. Louis	MO
St. Louis Assoc of Comm. Organizations	St. Louis	MO
Urban Homes St. Louis	St. Louis	MO
Humphreys County Union For Progress	Belzoni	MS
Friends of Children of Mississippi, Inc./EDWAA Project	Canton	MS
Mississippi Action for Community Education, Inc.	Greenville	MS
Jackson Metro Housing Partnership	Jackson	MS
Mississippi Institute for Small Towns, Inc.	Jackson	MS
Big River Housing Development Corp.	Marks	MS
Quitman County Development Org. Inc.	Marks	MS
Big River Housing Dev. Corp	Marsh	MS
Equipment County Federal Credit Union	Marsh	MS
Equipment County Dev. Organization	Marsh	MS
Mississippians United to End Homelessness	Meridian	MS
District 7 Human Resources Development Council	Billings	MT
Neighborhood Housing Services, Inc. of Great Falls	Great Falls	MT
District XI Human Resource Council	Missoula	MT
Women's Opportunity and Resource Development	Missoula	MT
Indian Center, Inc.	Lincoln	NB
New Community Development Corp.	Omaha	NB
Development Ventures, Inc.	Durham	NC
Hayti Development Corporation	Durham	NC
Operation Breakthrough, Inc.	Durham	NC
Triangle Housing Partnership	Durham	NC
Builford Native American Assoc., Inc.	Greensboro	NC
Greater Greensboro Housing Foundation	Greensboro	NC
Greensboro Housing Coalition	Greensboro	NC
Greensboro Episcopal Housing Ministry, Inc.	Greensboro	NC
West Greenville Community Dev. Corp.	Greenville	NC
Gospel Workshop, Inc.	Kinston	NC
Joint Orange-Charham Community Action, Inc.	Pittsboro	NC
Community Investment Corp. of North Carolina	Raleigh	NC
Downtown Area Revitalization Effort, PAC	Wilmington	NC
Community Action - Region VI	Jamestown	ND
Lincoln Action Program	Lincoln	NE
Lincoln Community Development Partnership	Lincoln	NE
Southeast Nebraska Development District	Lincoln	NE
Holy Name Housing Corporation	Omaha	NE
Mercy Housing Omaha	Omaha	NE
Omaha Economic Development Corporation	Omaha	NE
Camden Lutheran Housing Corp.	Camden	NJ
Metro Camden Habitat for Humanity	Camden	NJ
North Camden Land Trust	Camden	NJ
Community Access Unlimited, Inc.	Elizabeth	NJ
Fairmount Housing Corp.	Jersey City	NJ
PACO Inc.	Jersey City	NJ
YWCA of Hudson County	Jersey City	NJ

Lawrence Nonprofit Housing	Lawrencville	NJ
Mend, Inc.	Moorestown	NJ
Salt & Light Company, Inc.	Mt. Holly	NJ
Church Coalition for New Providence Affordable Hsg. Corp.	New Providence	NJ
Campaign for Human Development	Newark	NJ
Goal 6 - Newark, NJ	Newark	NJ
La Casa Don Pedro	Newark	NJ
Prince Hall Urban Renewal Corp.	Newark	NJ
Unified Vailsburg Services Organization	Newark	NJ
St. Paul's Community Initiatives, Inc./Services, Inc.	Paterson	NJ
The Monmouth Housing Alliance	Red Bank	NJ
Homes for All, Inc.	Toma River	NJ
Isles, Inc.	Trenton	NJ
Trenton Education Development Corporation	Trenton	NJ
Union County Housing Assistance Corp.	Union	NJ
The Westfield Senior Citizens Housing Corp.	Westfield	NJ
The Second Westfield Senior Citizens Housing Corp.	Westfield	NJ
Home Education Livelihood Program, Inc./Rural Housing, Inc.	Albuquerque	NM
United Way of Central New Mexico	Albuquerque	NM
Youth Development, Inc.	Albuquerque	NM
Youth Enterprises Systems, Inc.	Albuquerque	NM
Eastern Plains Housing Development Organization	Clovis	NM
Santa Fe Community Housing Trust	Santa Fe	NM
Women's Development Center	Las Vegas	NV
Arbor Hill Development Crop.	Albany	NY
Barn Raisers, Inc.	Albany	NY
Community Lending Corp.	Albany	NY
M-Ark Project, Inc.	Arkville	NY
Hanac, Inc.	Astoria	NY
Aquinas Housing Corporation	Bronx	NY
Argus Community, Inc.	Bronx	NY
Bronx Shepherds Restoration Corp.	Bronx	NY
Bronx Heights Neighborhood Community Corp	Bronx	NY
CCRP - Phipps CDC	Bronx	NY
MBD Community Housing Corp.	Bronx	NY
Mount Hope Housing Company	Bronx	NY
NEED	Bronx	NY
New Directions in Community Revitalization, Inc.	Bronx	NY
Pueblo En Marcha, Inc.	Bronx	NY
Rain Multi-Services	Bronx	NY
Simeon Service Foundation	Bronx	NY
Tremont Commonwealth Council Vocational Instruction	Bronx	NY
United Bronx Parents, Inc.	Bronx	NY
University Neighborhood Housing Center	Bronx	NY
West Bronx Housing & Neighborhood Resource Center, Inc.	Bronx	NY
Astella Development Corp.	Brooklyn	NY
Brooklyn Neighborhood Improvement Association	Brooklyn	NY
Brooklyn Ecumenical Cooperatives	Brooklyn	NY
Bushwick Information Coordinating & Action Committee, Inc.	Brooklyn	NY
Carroll Gardens Association, Inc.	Brooklyn	NY
Church Ave. Merchants Block Assoc., Inc.	Brooklyn	NY
Consortium for Community Development, Inc.	Brooklyn	NY
Council of Neighborhood Organizations, Inc.	Brooklyn	NY
Crown Heights Service Center, Inc.	Brooklyn	NY
Crown Heights Jewish Community Council	Brooklyn	NY
Cypress Hills Local Development Corp.	Brooklyn	NY
Erasmus Neighborhood Federation	Brooklyn	NY
Flatbush Development Corp.	Brooklyn	NY
Gowanus Community Development Corp.	Brooklyn	NY
Haitian Task Force on Housing	Brooklyn	NY
Local Development Corporation of Crown Heights	Brooklyn	NY
Neighborhood Women of Williamsburg/Greenpoint	Brooklyn	NY
Northeast Brooklyn Housing Development Corp.	Brooklyn	NY

NWR Associates Ltd. Partnership	Brooklyn	NY
Oceanhill Brownsville Tenants Association	Brooklyn	NY
Pastoral and Educational Services, Inc.	Brooklyn	NY
Pratt Area Community Council	Brooklyn	NY
Progress of Peoples Development Corp.	Brooklyn	NY
St. Nicholas Neighborhood Preservation Corp.	Brooklyn	NY
St. Marks Episcopal Housing Dev. Fund Corp.	Brooklyn	NY
Sunset Park Redevelopment Committee	Brooklyn	NY
The Local Dev. Corp. of Crown Heights, Inc.	Brooklyn	NY
Wayside R.C. Senior Citizens	Brooklyn	NY
Low Income Housing Development Clinic	Buffalo	NY
Stoneleigh Housing, Inc.	Canastota	NY
Catskill Mountain Housing Development Corporation	Catskill	NY
Cuba Community Dev. Corp.	Cuba	NY
Frontier Housing Corp.	Dexter	NY
Core Area Preservation Co., Inc.	Dunkirk	NY
Housing Assistance Program of Essex County, Inc.	Elizabethtown	NY
Elmhurst Economic Dev. Corp.	Elmhurst	NY
Chemung County Housing Coalition	Elmira	NY
Economic Opportunity Program, Inc.	Elmira	NY
Elmira Free Community Kitchen	Elmira	NY
Gateways Community Residence Program	Elmira	NY
Southern Tier Office of Social Ministry	Elmira	NY
Westhab, Inc.	Elmsford	NY
Rockaway Development & Revitalization Corp.	Far Rockaway	NY
Pembrook Neighborhood Center, Inc.	Flushing	NY
Community United Today, Inc.	Geneva	NY
Finger Lakes Office of Social Ministry	Geneva	NY
Long Island Housing Partnership, Inc.	Hauppauge	NY
Neighborhood Preservation & Dev. Corp.	Jamaica	NY
Citizen's Opportunity for Development & Equality	Jamestown	NY
Southern Tier Environments for Living	Jamestown	NY
Friends of the North Country, Inc.	Keeseville	NY
Rural Sullivan County Housing Opportunities, Inc.	Monticello	NY
Genesee Valley Rural Preservation Council, Inc.	Mt. Morris	NY
Rockland Community Action Council, Inc.	Nanuet	NY
Abyssinian Development Corp.	New York	NY
Access Development Fund	New York	NY
Asian Americans for Equality	New York	NY
Assoc. for Nbrhd. & Housing Dev./Community Housing Assoc.	New York	NY
BRC Human Services Corp.	New York	NY
Clinton Housing Development Company, Inc.	New York	NY
Columbia Kavanaugh Housing, Inc.	New York	NY
Common Ground Community HDFC, Inc.	New York	NY
Community League of W. 159th Street, Inc.	New York	NY
Community Access, Inc.	New York	NY
Consumer - Farmer Foundation, Inc.	New York	NY
Cooper Square Committee	New York	NY
CVCS	New York	NY
DFDS Development Corp.	New York	NY
Ecumenical community Development Organization	New York	NY
El Barrio's Operation Fightback, Inc.	New York	NY
Elmcor	New York	NY
Good Shepherd Services	New York	NY
Good Old Lower East Side	New York	NY
Grosvenor Neighborhood Housing	New York	NY
Harlem Restoration Project, Inc.	New York	NY
Harlem Teams for Self-Help, Inc.	New York	NY
Housing 2000 HDFC & Canaan Baptist Church of Christ	New York	NY
Housing Development Institute (Archdiocese of NY)	New York	NY
Institute for the Puerto Rican... Action Council	New York	NY
La Casa de Don Pedro, Inc.	New York	NY
Lawyers Alliance for New York	New York	NY
Lenox Hill Neighborhood Association	New York	NY

Local Development Corp. Del Barrio. Inc.	New York	NY
Lower East Side Coalition Housing Dev.. Inc.	New York	NY
Manhattan Borough Dev. Corp.	New York	NY
Manhattan Valley Management Company	New York	NY
Metro New York Coordinating Council on Jewish Poverty	New York	NY
Nazareth Housing	New York	NY
New York City Rural Advocates	New York	NY
New York Foundling Hospital - ProBase. Inc.	New York	NY
Northern Manhattan Development Corp.	New York	NY
NY Urban Coalition Housing Group	New York	NY
People's Mutual Housing Assoc. of the Lower East Side	New York	NY
Puerto Rican Workshop, Inc.	New York	NY
Serviles for the Underserved	New York	NY
SRO Providers Group	New York	NY
The Bridge, Inc.	New York	NY
The Jericho Project	New York	NY
Urban Pathways, Inc.	New York	NY
West Side Federation for Senior Housing, Inc.	New York	NY
Niagara Falls Neighborhood Housing Services. Inc.	Niagara Falls	NY
Leviticus 25:23 Alternative Fund, Inc.	Ossining	NY
Housing Opportunities	Rochester	NY
Lewis St. Center, Inc.	Rochester	NY
Rural Opportunities, Inc.	Rochester	NY
Sojourner Development Corp.	Rochester	NY
Roosevelt Island Seniors Assoc.	Roosevelt Is.	NY
Western Catskills Community Revitalization Council. Inc.	Stamford	NY
Richmond Senior Services, Inc.	Staten Island	NY
West Brighton Community Local Dev. Corp.	Staten Island	NY
Housing Visions	Syracuse	NY
PEACE, Inc.	Syracuse	NY
Reformed Church in America	Tarrytown	NY
Southern Hills Preservation Corp.	Tully	NY
Community Services Program, Inc.	Wappingers Fls	NY
North Country Affordable Housing, Inc.	Watertown	NY
Cincinnati Development Fund	Cincinnati	OH
Franciscan Home Development, Inc.	Cincinnati	OH
Miami Purchase Preservation Fund	Cincinnati	OH
Neighborhood Development Corp. Assoc. of Cincinnati	Cincinnati	OH
Boys & Girls Club of Cleveland	Cleveland	OH
Broadway Area Housing Coalition	Cleveland	OH
Buckeye Area Development Corp.	Cleveland	OH
Collinwood Area Development Corp.	Cleveland	OH
Collinwood & Waterloo Development, Corp.	Cleveland	OH
Council for Economic Opportunities in Greater Cleveland	Cleveland	OH
Famicos Foundation	Cleveland	OH
Family Transitional Housing	Cleveland	OH
Friends of Shaker Square, Inc.	Cleveland	OH
Glenville Development Corp.	Cleveland	OH
Mavrick House	Cleveland	OH
Mount Pleasant Now Development Corp.	Cleveland	OH
Mt. Pleasant Now Development Corp.	Cleveland	OH
Near West Housing Corp.	Cleveland	OH
Neighbors Organized for Action in Housing	Cleveland	OH
St. Clair Superior Coalition	Cleveland	OH
Stockyard Area Development Assoc.	Cleveland	OH
The Living in Cleveland Ctr., Inc.	Cleveland	OH
The LeBlond Housing Corporation	Cleveland	OH
Transitional Housing, Inc.	Cleveland	OH
Tremont West Development Corp.	Cleveland	OH
University Settlement	Cleveland	OH
Stock Yard Area Development Assoc.	Clinton	OH
Columbus Housing Partnership	Columbus	OH
Friends of the Homeless	Columbus	OH
Lutheran Social Services of Central Ohio	Columbus	OH
Northside Development Corp.	Columbus	OH
County Corp.	Dayton	OH

Oikos Community Dev. Corp	Dayton	OH
Partners in Rebuilding Dayton, Inc.	Dayton	OH
Lutheran Housing Corporation	East Cleveland	OH
HHWP Community Action Commission	Findlay	OH
Rehab Project	Lima	OH
Brown Dura Collingwood Dev. Corp	Toledo	OH
Neighborhoods in Partnership	Toledo	OH
North River Management Co.	Toledo	OH
North River Development	Toledo	OH
Planning Concepts	Toledo	OH
Toledo Warehouse District Assoc.	Toledo	OH
Warren-Sherman CDC	Toledo	OH
Neighborhood Housing Services of Tulsa, Inc.	Tulsa	OK
Baker County Community Development Corporation	Baker City	OR
Southwestern Oregon Community Action Committee, Inc.	Coos Bay	OR
Corvallis Neighborhood Housing Services, Inc.	Corvallis	OR
Neighborhood Economic Development Corp.	Eugene	OR
Washington County Community Action Organization	Hillsboro	OR
Rogue Valley Community Development Corp.	Medford	OR
Northwest Housing Alternatives	Milwaukie	OR
Association of Oregon Community Dev. Organizations	Portland	OR
Franciscan Enterprise	Portland	OR
Housing Our Families	Portland	OR
Metro Community Development Corp.	Portland	OR
Neighborhood Partnership Fund	Portland	OR
Northeast Community Dev. Corp.	Portland	OR
Reach Community Development	Portland	OR
Rose Community Dev. Corp.	Portland	OR
Transition Projects	Portland	OR
Central Housing & Community Development Concerns, Inc.	Redmond	OR
Oregon Housing & Associated Services, Inc.	Salem	OR
Community Action Team, Inc.	St. Helens	OR
Improved Dwellings for Altoona, Inc.	Altoona	PA
Northern Cambria Community Development Corp.	Barnesboro	PA
Community Action Committee of the Lehigh Valley	Bethlehem	PA
Lehigh Valley Coalition on Affordable Housing	Bethlehem	PA
Interfaith Housing Dev. Corp.	Bristol	PA
Duquesne Business Advisory Corp.	Duquesne	PA
Glassport Dev. Corp	Glassport	PA
Harrisburg Community & Economic Affairs	Harrisburg	PA
South Central PA Housing Dev. Foundation	Harrisburg	PA
Tri-County Commission for Community Action	Harrisburg	PA
Mon Valley Initiative	Homestead	PA
Housing Development Corp.	Lancaster	PA
Susquehanna Valley Community Dev. Loan Fund	Lancaster	PA
The Community Action Program of Lancaster County	Lancaster	PA
Bucks County Housing Group	Langhorne	PA
McKeesport Housing Corporation	McKeesport	PA
1260 Housing Development Corporation	Philadelphia	PA
Advocate Community Dev. Corp.	Philadelphia	PA
C.O.L.T. Coalition	Philadelphia	PA
Community Ventures, Inc.	Philadelphia	PA
Fund for an OPEN Society	Philadelphia	PA
Greater Germantown Housing Dev. Corp.	Philadelphia	PA
Housing Consortium for Disabled Individuals	Philadelphia	PA
Hunting Park Community Dev. Corp.	Philadelphia	PA
Jefferson Manor Development Corp, Inc.	Philadelphia	PA
Kensington Action Now/Area Revitalization Project	Philadelphia	PA
National Temple Non Profit Corp.	Philadelphia	PA
New Manayuok Corporation	Philadelphia	PA
Norris Square Civic Association	Philadelphia	PA
Octavia Hill Assoc., Inc.	Philadelphia	PA
Parkside Assoc.of Philadelphia	Philadelphia	PA
Project Home	Philadelphia	PA

Southwest (Philadelphia) Community Dev. Corp.	Philadelphia	PA
The Allegheny West Foundation	Philadelphia	PA
The West Philadelphia Partnership CDC	Philadelphia	PA
Urban Partners	Philadelphia	PA
Wister Neighborhood Council/ Advisory Committee	Philadelphia	PA
Wright Lutheran CDC	Philadelphia	PA
Action Housing, Inc.	Pittsburgh	PA
Community Human Services Corp.	Pittsburgh	PA
HBRDC	Pittsburgh	PA
Northside Civic Development Council	Pittsburgh	PA
South Side Local Development Company	Pittsburgh	PA
Interfaith Community Development Corporation, Inc.	Pottstown	PA
Catherine McAuley Center	Scranton	PA
Lackawanna Housing Dev. Corp	Scranton	PA
Scranton Neighborhood Housing Services, Inc.	Scranton	PA
Community Housing Service, Inc.	Tensdale	PA
Lorner Cupboard Food Bank of Green County	Waynesburgh	PA
The Bristol Foundation	Bristol	RI
Statewide Affordable Housing	Newport	RI
Pawtucket Citizens	Pawtucket	RI
SWAP, Inc. (Stop Wasting Abandoned Property)	Providence	RI
Charleston Affordable Housing, Inc.	Charleston	SC
Trinity Housing Corporation	Columbia	SC
Northeast South Dakota Energy Conservation Corp.	Sisseton	SD
Chattanooga Neighborhood Enterprise	Chattanooga	TN
K.I.T.E., Inc.	Kingsport	TN
Center for Neighborhood Development	Knoxville	TN
Knox Housing Partnership, Inc.	Knoxville	TN
Dunnavant Street Neighborhood Club	Memphis	TN
Neighborhood Housing Opportunities, Inc.	Memphis	TN
Tennessee Network for Community Economic Development	Nashville	TN
The Resource Foundation, Inc.	Nashville	TN
Austin Housing Finance Corp.	Austin	TX
Central Texas Mutual Housing Assoc.	Austin	TX
Helping Our Brothers Out, Inc.	Austin	TX
The American Institute for Learning	Austin	TX
Community Development Corporation of Brownsville	Brownsville	TX
Gulf Coast Council of La Raza, Inc.	Corpus Christi	TX
Lawyers for Affordable Housing	Dallas	TX
Oak Cliff Development Corp.	Dallas	TX
Habitat for Humanity of El Paso	El Paso	TX
Lower Valley Housing Corp.	Fabens	TX
Reach of Dallas Resource Ctr. on Independent Living	Fort Worth	TX
Liberation Community, Inc.	Ft. Worth	TX
United Way of Metropolitan Tarrant County	Ft. Worth	TX
Galveston Community Development Co-Op	Galveston	TX
St. Vincent's Episcopal House	Galveston	TX
Williamson Burnet County Opportunities, Inc.	Georgetown	TX
Acres Homes Community Dev. Corp	Houston	TX
Dowling Area CDC	Houston	TX
Fifth Ward Community Redevelopment Corporation	Houston	TX
Houston Habitat for Humanity	Houston	TX
Houston Community Services	Houston	TX
Houston Area Urban League	Houston	TX
Houston Inter-Faith Housing Corp.	Houston	TX
McAllen Affordable Homes, Inc.	McAllen	TX
Texas Enterprise for Housing Dev., Inc.	McAllen	TX
Midland Affordable Housing Roundtable	Midland	TX
Midland Housing Finance Corp.	Midland	TX
His Works Ministries	Richmond	TX
Bekar County Local Development Corp.	San Antonio	TX
Rural Rental Housing Assoc. of Texas	Temple	TX
Jerusalem Community Development Corporation	Wichita Falls	TX
Assist, Inc. - A Community Design Center	Salt Lake City	UT

Institute of Human Resource Development	Salt Lake City	UT
Unitarian-Universalist Affordable Housing Corp.	Alexandria	VA
Wesley Housing Dev. Corp.	Alexandria	VA
Arlington Partnership for Affordable Housing, Inc.	Arlington	VA
Robert Pierce Johnson Housing Development Corp.	Arlington	VA
Dungannon Dev. Comm./Housing Ent. for Low-Income People	Dungannon	VA
New Land Jobs	Lynchburg	VA
White Oak Neighborhood Council, Inc.	Lynchburg	VA
Richmond Neighborhood Housing Services, Inc.	Richmond	VA
Southside Community Development Corporation	Richmond	VA
Task Force for Historic Preservation and the Minority Comm.	Richmond	VA
Virginia Water Project, Inc.	Roanoke	VA
Appalachian Office of Justice & Peace	St. Paul	VA
Highgate Non-Profit, Inc.	Barre	VT
S.E.V.C.A.	Bellows Falls	VT
Abbott Group, Inc.	Brattleboro	VT
Brattleboro Area Community Land Trust	Brattleboro	VT
Addison Co. Parent Child Center	Middlebury	VT
Central Vt. Comm. Land Trust	Montpelier	VT
The Housing Foundation, Inc.	Montpelier	VT
Vermont Housing Enterprises, Inc.	Montpelier	VT
Lamoille Housing Partnership, Inc.	Morrisville	VT
Gilman Housing Trust, Inc.	Newport	VT
Northern Community Housing Corp.	Saint Johnsbury	VT
Northern Community Investment Corp.	Saint Johnsbury	VT
Aberdeen Neighborhood Housing Services	Aberdeen	WA
United Way of Snohomish County	Everett	WA
Pathways for Women	Lynnwood	WA
Neighborhood Housing Services of Eastern WA	Makton	WA
Southern Puget Sound Inter-Tribal Housing Authority	Olympia	WA
New Horizons	Prescott	WA
Compass Center	Seattle	WA
Environmental Works Community Design Center	Seattle	WA
Evergreen Community Development Assoc.	Seattle	WA
S. E. Effective Development	Seattle	WA
Seattle Housing Resources Group	Seattle	WA
Seattle, Chinatown Internat. Dist. Preservation	Seattle	WA
Seattle King County Housing Dev. Consortium	Seattle	WA
Spokane Low Income Housing Consortium	Spokane	WA
Washington Low Income Housing Congress	Spokane	WA
Metropolitan Development Council	Takoma	WA
Upper Takoma Rennaissance Association	Takoma	WA
Blue Mountain Action Council	Walla Walla	WA
ADVOCAP	Fond du Lac	WI
The Wisconsin Partnership for Housing Development, Inc.	Madison	WI
Wisconsin Community Action Program Assoc.	Madison	WI
Lakeshore CAP, Inc.	Mamtowoe	WI
Neighborhood House Of Milwaukee, Inc.	Millwaukee	WI
Aurora Weier Educational Center	Milwaukee	WI
Milwaukee Housing Assistance Corp.	Milwaukee	WI
Milwaukee Indian Economic Development Agency	Milwaukee	WI
Northwest Milwaukee Industrial Dev. Corp.	Milwaukee	WI
Richardson Manor	Milwaukee	WI
Sherman Park Community Assoc.	Milwaukee	WI
Southeastern WI. Center for Independent Living, Inc.	Milwaukee	WI
The Westown Association	Milwaukee	WI
Transitional Living Services, Inc.	Milwaukee	WI
Westside Housing Coop	Milwaukee	WI
Wisconsin Preservation Fund, Inc.	Milwaukee	WI
CAP Services, Inc.	Stevens Point	WI
NWCSA, Inc.	Superior	WI
Community Works of West Virginia, Inc.	Elkins	WV
The Central Wyoming Rescue Mission	Casper	WY

Mr. PAYNE. Thank you very much, Mr. Grogan, and thank you all very much for very insightful testimony.

I think generally we have heard that you are all very much in favor of the low-income housing tax credit. There are some amendments that are being suggested that might be proposed.

Let me just ask about one of those that Mr. Wilkins mentioned and that is rehabilitation and the way that it might be restructured to perhaps improve the program.

Would any of the other panelists care to comment on the proposal that Mr. Wilkins suggested in his testimony?

Mr. HARVEY. I have not seen it yet. I would need to analyze it before saying something about it.

Mr. PAYNE. Well, I think it addressed the concern about how effectively the low-income housing credit might be used for rehabilitation of housing because of the way it is currently structured. Mr. Wilkins was proposing a specific way that programs might be changed and I didn't know if others had had experience with that same problem.

I don't know if the Enterprise Foundation, for instance, does any rehabilitation.

Mr. HARVEY. We do. The low-income housing tax credit can be used for rehabilitation right now. I think what their proposal was addressing is our current investors that own property and their problems with exit taxes and finding a way to allow the tax credit to work without triggering those exit taxes that they might have.

I think we would need to study it and look at it. The tax credit, as Mr. Grogan said, is very flexible the way it is constituted right now, but it does not work in the specific case that was mentioned.

Mr. PAYNE. Thank you.

Mr. WILKINS. This is something whose time has come. The properties we are talking about are aging. Several years ago when the credit was first proposed, the properties were much younger then, they were not in the condition we see now and we see over the next 10 years.

So we think this is an appropriate idea that the allocating agencies and the States should have the opportunity to consider rehabilitation of existing affordable housing as well as the whole range of other flexible uses of the credit which have been mentioned.

We think the way we proposed it is a very efficient way of utilizing the credits so that essentially all of the credit flows directly to the preservation of the housing. So we think this is a good idea and would be pleased to explore it further with the committee.

Mr. PAYNE. As I understand it from what Mr. Harvey said, this applies in a situation where you have original investors who are being replaced by new investors, and your suggestion is that the tax treatment would be the same as if the original investors were making the new investment?

Mr. WILKINS. Yes, in effect.

Mr. PAYNE. Thank you very much.

Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

I would like to ask Mr. Jackson a question, because you spoke on the enterprise zones. The administration is still attempting to put together their enterprise zone package, but it is not in any de-

tail at this time so we cannot speak about specifics. However, one big concern that people have about enterprise zones is how do you prevent one company from leaving an area that is marginal, moving to an enterprise zone area, taking advantage of the credits or deduction or whatever else we might give the new business, which results basically in a loss of revenue to the Federal Treasury, while that company doesn't actually create any jobs in, let's say the entire county or the entire geographic area, but does create jobs in the enterprise zone but to the detriment of some other group?

To a large extent, it seems that what we are talking about is a zero sum gain. If you think of a market economy, if a business wants to start up, it will start up and, obviously, it will go to the least expensive place to do so. But there has to be a demand out there for their particular services or product.

So what will prevent mere movement from one region to another, to the detriment of the region they are leaving?

Mr. JACKSON. Well, I have not thought through what will be some punitive ways to control say the abuse in terms of the enterprise where you would have, as you said, a zero sum gain, that is no increase in jobs.

One of the ways, I think, and this is part of my written testimony, is that because of the severe economic hardship, in southern California, we don't have local revenues for matching some of the activities; that when you combine it with other Federal programs, you could probably look at some curtailments or some controls that will allow us to avoid situations like that, where a company is just taking advantage of the benefits and not really giving something in return to the public.

You have to look at other programs that could be built into the criteria. I don't have a solution now as to that particular point, that kind of a scenario, but my perspective is to look at the positive things that could be done and try to build some mechanism, as I mentioned, such as other Federal resources that will reduce or minimize that kind of an exposure.

Mr. MATSUI. I guess, for example, I do favor the low-income housing credits, and I think they are very valuable and I would like to see them made permanent. We have been working to make it permanent for years and years and years, and the reason behind doing so is because we know we have to when you target a particular function or a particular industry if its needs are to be met. In those cases, absent some major significant deduction, the marketplace doesn't work for those targeted areas.

But I am afraid, and again I am open minded about this, but I have never been a particular advocate of enterprise zones because we would be micromanaging the economy and the net result may not be to create any additional jobs or increase gross domestic product any, and there may be other ways to meet the need.

Again, obviously, the administration purports that it be part of our package, but if you could try to come up with a way to ensure that we do not simply create this problem of one industry moving from one location to another location, I think that would alleviate a lot of concerns I and perhaps other Members might have as well.

I have never, as I said, been particularly fond of the concept of enterprise zones. In fact, I think it is a misnomer. I mean this was

the Jack Kemp suggestion, and he used the word enterprise to make it sound like it is a free enterprise approach, but it is not. It is the opposite of that; it is managed government involvement in the economy.

I am skeptical, but, nevertheless, I am willing to have an open mind on this.

Mr. JACKSON. If you look at history, under the urban development action grants, you had situations where you had cities recruiting from other cities for industrial development. So you had one city benefiting, the other one experiencing a negative impact on their economy. I believe that there was some criteria built in to avoid those kind of situations. Again, we have to look at building in mechanisms that would give you positive results.

We are looking at probably medium sized to small businesses that will take advantage of the enterprise zones, not the large companies.

Mr. MATSUI. Thank you.

[The following letter was subsequently received:]

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County of Los Angeles

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Commissioners

Gloria Molina
Yvonne Brathwaite Burke
Edmund D. Edelman
Deane Dana
Michael D. Antonovich

Carlos Jackson
Executive Director

April 6, 1993

Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515-6348

Dear Honorable Members:

It was an honor for me to me to appear before your Committee to represent the County of Los Angeles on the issue of the proposed Federal Enterprise Zone. At the conclusion of the testimony by the panel of which I was a part, Representative Robert Matsui commented that he had an open mind regarding supporting Federal enterprise zone legislation, but he had certain reservations, which I would like to briefly address.

Representative Matsui was concerned about the potential for businesses relocating from one area into an Enterprise Zone to take advantage of the incentives offered, resulting in a loss of revenue to the Federal Treasury, but not creating any additional jobs. He asked what measures could be taken to prevent such a result.

This is an issue of concern to the County of Los Angeles as well. H.R. 15 authored by Representative Rangel addressed this issue by specifically prohibiting local governments from "any action" to assist a business to relocate from an area into the Federal enterprise zone. This would include any local incentives to lure a business into a zone. If relocatees are prohibited from taking advantage of the full zone incentives it reduces an inducement to for a business to incur the cost and disruption of business operations associated with relocating.

In addition, we believe the "local empowerment" emphasis on assisting the expansion of small to medium sized firms already located in the zone, and special incentives to start-up firms will increase job opportunities for local residents, and in the long-run, raise federal revenues. Marketing efforts would strongly emphasize business expansion and new business creation.

We believe these efforts would reduce the chances of alleviating blight in one area at the expense of a neighboring area and the mere shifting of jobs from one distressed area to another.

Ways and Means Committee
April 6, 1993
Page 2

Representative Matsui was also concerned that the Federal enterprise zone concept seems to be micro-managing by government and that it is not a free enterprise approach. My response is that the private sector abandoned these areas for suburban locations which exacerbated the deterioration of our inner cities. I believe that, only through government intervention, at least on a short term basis will businesses be induced to provide job generating investment in our major population centers with high unemployment in the inner cities. Though not a cure-all, a carefully crafted Federal enterprise zone program coupled with needed improvements in physical appearance, services and infrastructure, will help create a level playing field for our inner cities as they compete for new business ventures and business expansion opportunities with suburban areas.

I was very gratified that Representative Matsui may support the Federal enterprise zone legislation. If necessary, I would welcome a future presentation before yours or any other Congressional Committee on this critical component to our economic revitalization effort.

Very truly yours,

Carlos Jackson

CARLOS JACKSON,
Executive Director

CC:congress4-7-93

Mr. PAYNE. Mr. Bunning.

Mr. BUNNING. No questions.

Mr. PAYNE. Well, I would like to thank the panel very much for your testimony. You have been very helpful to the committee as we continue our deliberations.

I want to say to Mr. Harvey and Grogan, thank you for being here for 5 consecutive years testifying on the same subject, and I would hope the next time you are here it is a different subject.

Thank you very much.

Mr. HARVEY. Thank you.

Mr. GROGAN. Thank you.

Mr. PAYNE. Our next panel will consist of the National Council of State Housing Agencies, Trudy McFall and Peter Dwars; the National Realty Committee, Steven Wechsler and Michael Hackard; the National Association of Realtors, Robert Elrod; the National Association of Home Builders, Roger Glunt; and the Mortgage Bankers Association of America, Mr. Herbert Tasker.

I understand Mr. Tasker has a 2:30 flight, so if the others of you don't object we will let him testify first so he can leave after his testimony.

All the written testimony will be entered into the record, and you can proceed with your oral testimony as you choose.

Mr. Tasker.

STATEMENT OF HERBERT B. TASKER, PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA, AND CHIEF EXECUTIVE OFFICER AND CHAIRMAN OF THE BOARD, ALL PACIFIC MORTGAGE CO., CONCORD, CA

Mr. TASKER. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am Herbert B. Tasker, CEO and chairman of the board of All Pacific Mortgage Co. of Concord, CA. I am currently serving as president of the Mortgage Bankers Association of America, MBA. We appreciate the opportunity to appear before the committee today to comment on the administration's deficit reduction plan as well as several issues that are critical to our industry and to home owners across the country.

MBA supports the administration's initiative to reduce the Federal deficit in the housing arena. MBA urges the administration and Congress to confine modifications in the direction of increased fairness and programs that enhance affordability and the Nation's home ownership rate. The administration's package contains a provision to provide partial relief for those individual taxpayers materially involved in rental real estate.

However, MBA believes several additional provisions need to be added to the administration's proposal affecting real estate lending and development.

MBA supports the inclusion of H.R. 749 introduced by Representative Mike Andrews. MBA is pleased that the administration's plan does not propose any restrictions or limitations on the ability of home owners to deduct mortgage interest. Such restrictions would increase home ownership costs.

MBA supports the full tax deductibility of residential mortgage interest expenses, including the interest on second homes and all

refinanced mortgages. The tax deductibility of home mortgage interest and real estate taxes on residences is consistent with the Nation's longstanding commitment to home ownership opportunities for all American families.

In general, the elimination or limitation of interest deductibility will have significant adverse effects on the prospects of the economy, on home buyers, and on the housing industry. Families residing in the Northeast and Western regions of the country, where housing costs are higher, would bear the greatest share of the burden in the event the current $1 million cap is lowered or itemized deductions are limited.

MBA is the trade association for the industry that originates and services the largest percentage of home mortgages in the country. In this capacity, MBA has a deep concern with any legislation that affects the ability of home buyers to purchase a home. While MBA supports the premise of tax simplification, the mortgage lending industry is concerned about the inclusion of a proposal in the House tax stimulus package to alter the amortization of purchase mortgage servicing rights, PMSR.

MBA opposes the inclusion of PMSR with intangible assets in the 14-year amortization category. MBA believes that PMSR's are distinguishable from intangible assets because, number one, servicing rights have a determined average life; second, the value of servicing rights is quantifiable because there is an active market for PMSR, and, finally, financial institution regulators recognize the tangible value of the asset and allow PMSR to count toward capital requirements.

The mortgage servicing industry has developed sophisticated models to project the life of mortgage servicing portfolios. For example, to ensure that prices that are paid for these portfolios reflect their long-term economic value. Mortgage servicing is valued, among other things, by examining the stated servicing fees on the loan, the cost to service the loan, the investor's required yields and an examination of historical data on the actual experience of mortgage payments.

Most mortgages are paid off in 7 to 10 years and most mortgage servicing is amortized over a 7-to-10-year period. Both the IRS and the Tax Court have established that PMSR has an acceptable measurable life, thus the proposed change would undo existing law by creating an arbitrary life for the asset. Changing the amortization of the PMSR would increase the cost of housing for low, moderate- and middle-income borrowers.

Mortgage interest rates could increase as much as 12½ basis points.

Purchase mortgage servicing rights are among the best assets regulated financial institutions can hold. PMSR's have a predictable stream of income and are useful portfolio management tools. Given the trend towards increased securitization of mortgages for single and multifamily housing, banking and thrift regulators have concluded that the marketability of all servicing will thrive.

These assumptions by the regulators will be erroneous if the tax treatment of mortgage servicing is altered. If PMSR is decreased in value, banks and thrifts will be forced to find new sources to meet core capital and Tier I capital requirements.

We appreciate the opportunity to testify and will be happy to furnish any additional information to you, Mr. Chairman.

Mr. PAYNE. Thank you very much, Mr. Tasker.

[The prepared statement follows:]

TESTIMONY OF HERBERT B. TASKER
Mortgage Bankers Association of America

Mr. Chairman and Members of the Committee, I am Herbert B. Tasker, CEO and Chairman of the Board of All Pacific Mortgage Company of Concord, California. I am currently serving as President of the Mortgage Bankers Association of America (MBA)[1]. I am accompanied today by Michael J. Ferrell, MBA Senior Staff Vice President and Legislative Counsel, and Jim Freeman, MBA Assistant Director for Legislation.

We appreciate the opportunity to appear before the Committee today to comment on the Administration's deficit reduction plan, as well as several issues that are critical to our industry and to homeowners across the country.

The President's plan has already had a beneficial effect on real estate finance as home mortgage interest rates have declined since the President announced his program. We are in the midst of a refinancing resurgence, which along with downward adjustable rate mortgage (ARMs) adjustments, will help the economy as more disposable income is placed in the hands of homeowners. Last year, homeowners freed up about $16 billion in lower debt service due to refinancings and adjustments made to their ARMs. We are projecting

similar savings this year, and this increase in spendable income should give a significant boost to our recovering economy.

President's Economic Stimulus Package. MBA supports the Administration's initiative to reduce the Federal deficit. Specifically, MBA strongly supports the Administration's efforts to reduce the deficit by at least fifty percent over the next four years. Further, MBA encourages the Administration and Congress, as changes may be made to the Adminstration's initial program, to work in the direction of increased spending cuts and smaller tax increases. In the housing arena, MBA urges the Administration and Congress to confine modifications in the direction of increased fairness and programs that enhance affordability and the nation's homeownership rate.

Passive Loss Rules. The 1986 Tax Reform Act restricted the deductibility of losses from rental real estate. The Act created the passive activity category of income and losses. Investment in rental real estate is regarded as a passive activity, regardless of whether a taxpayer "materially participates" in the activity. Thus, passive losses and credits can only be used to offset income from other passive activities.

Under current law, taxpayers regularly, continuously, and substantially engaged in rental real estate activities cannot deduct legitimate expenses exceeding the income derived from the rental property. For example, if expenses are needed to maintain the property, such as repairing heating and air conditioning equipment, repaving parking lots, etc., and these expenses exceed the rental income derived, the excess costs cannot be deducted for tax purposes. Thus, current law provides disincentives to repair, improve, and maintain existing rental properties, resulting in property deterioration, value declines, and erosion of local tax bases. In addition, taxpayers whose primary business involves the rental of income properties are disadvantageously and unfairly treated under the Tax Code. MBA supports tax parity for taxpayers materially engaged in rental real estate activities.

The Administration's package contains a provision to provide partial relief for those individual taxpayers materially involved in rental real estate. However, MBA believes

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[1]MBA is the national association representing exclusively the real estate finance industry. Headquartered in Washington, D.C., the association works to ensure the continued strength of the Nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies; savings and loan associations; commercial banks, savings banks; life insurance companies; state housing finance agencies; and others in the mortgage lending field.

several additional provisions need to be added to the Administration's proposals affecting real estate lending and development.

MBA supports the inclusion of HR 749, introduced by Representative Mike Andrews (D-TX). Specifically, the Andrews bill would modify Section 108 of the Tax Code to permit taxpayers to exclude discharge of qualified real property indebtedness from their gross income. The amount excluded from gross income would be applied to reduce the taxpayers' depreciable real property basis. Currently, a solvent borrower receiving relief from debt secured by commercial real estate (not involved in a Federal bankruptcy case), must declare the amount of that relief as gross income. Thus, current law discourages both lenders and borrowers from renegotiating a mutually beneficial debt arrangement by requiring the taxpayer to declare any debt relief as gross income. HR 749 would permit the property to operate profitably; would allow the borrower to stay afloat; and would encourage prompt payment of debt service. Rather, holding other factors constant, this provision under the current tax code encourages bankruptcy filings. HR 749 would eliminate such incentives

to file bankruptcy, while simultaneously preventing tax shelter abuses by limiting the amount of these deductions.

Most importantly, MBA believes the provision in HR 749 to change the rule of "Five or Fewer" for Real Estate Investment Trusts (REIT) is critical to the long term stability of commercial real estate investment. Currently, no more than 50 percent of a REIT may be owned by five or fewer individuals. Unlike foreign pension plans, domestic pension funds are treated as a single individual for tax purposes, which constrains the ability of pension funds to invest in REITs. The Andrews proposal would remove this impediment and we believe that it would enhance the flow of capital to real estate, and place U.S. pension plans on a par with foreign plans.

<u>Low-Income Tax Credit.</u> MBA supports the Administration's plan to extend the low income housing tax credit permanently. The tax credit is the most significant Federal initiative to encourage the production and rehabilitation of very low-, low-, and moderate-income rental housing. The tax credit program has been used in the preservation of over 600,000 low income housing units. MBA commends Chairman Rostenkowski (D-IL) and Representative Rangel (D-NY) for introducing HR 18, which extends the low income tax credit permanently.

<u>Mortgage Interest Deduction.</u> MBA is pleased that the Administration's plan does not propose any restrictions or limitations on the ability of homeowners to deduct mortgage interest. Such restrictions would increase homeownership costs. MBA supports the full tax deductibility of residential mortgage interest expenses, including the interest on second homes and all refinanced mortgages. The tax deductibility of home mortgage interest and real estate taxes on residences is consistent with the Nation's long standing commitment to homeownership opportunities for all American families.

In general, the elimination or limitation of interest deductibility will have significant adverse effects on the prospects of the economy, on homebuyers, and on the housing industry. Families residing in the Northeast and Western regions of the country, where housing costs are higher, would bear the greatest share of the burden in the event the current $1 million cap is lowered to $200,000. Mortgages exceeding $200,000 total about $435 billion, representing 7.35 million loans. These mortgages represent the potential target base of the home mortgage interest deduction proposals.

More purchasers in these areas will reach the deduction limits because higher mortgage amounts are due to higher house prices. These areas have the largest number of jumbo mortgages--those in excess of $203,500.

<u>Purchased Mortgage Servicing Rights (PMSR)</u>

MBA is the trade association for the industry that originates and services the largest percentage of home mortgages. In this capacity, MBA has a real concern in any legislation that affects the ability of homebuyers to purchase a home. While MBA supports the premise of tax simplification, the mortgage lending industry is concerned about the inclusion of a proposal in a House tax stimulus package to alter the amortization of purchased

mortgage servicing rights (PMSR). Tax simplification would be a significant step toward clarifying and providing uniformity to a very controversial area of the law. We strongly believe the simplification aspect, as it applies to PMSR, is being championed to such an extent that many long-term risks to the economy and to consumers are being overshadowed or overlooked.

MBA opposes the inclusion of PMSR with intangible assets in the 14-year amortization category. MBA believes that PMSRs are distinguishable from intangible assets because: (1) servicing rights have a determined average life; (2) the value of servicing rights is quantifiable because there is an active market for PMSR; and (3) financial institutions regulators recognize the tangible value of this asset and allow PMSR to count towards capital requirements.

The mortgage servicing industry has developed sophisticated models to project the life of mortgage servicing portfolios, for example, to ensure that prices that are paid for these portfolios reflect their long-term economic value. Mortgage servicing is valued among other things, by examining the stated servicing fees on the loan, the costs to service the loan, the investors' required yields, and an examination of historical data on the actual experience of mortgage payments. Most mortgages are paid off in seven to ten years, and most mortgage servicing is amortized over a seven- to ten-year period.

Both the IRS and the Tax Court have established that PMSR has an acceptable measurable life. Thus, the proposed change would undo existing law by creating an arbitrary life for the asset. Because the law in this area is settled, the change in the amortization would not result in lowered costs. Hence, the rationale is flawed and there are no benefits from establishing a uniform rule for PMSR.

Requiring a 14-year amortization of PMSR will increase the tax burden on PMSR. If the mortgage lending industry had been forced to use the 14-year straight line depreciation method in 1990, the mortgage lending industry's tax burden would have been about $150 million higher than under current law. The fact that the present value of the 14-year straight line amortization schedule is less than the amortization schedule currently in use means that the present value of the tax burden on PMSR would be higher. For the average mortgage lending institution--the 1990 tax burden would have been $33,125 higher than their actual tax burden. Because the mortgage lending industry is very competitive, this increase in tax burden in all probability will be passed onto consumers in the form of higher mortgage interest rates or fees. Although the proposal was constructed to be revenue neutral, it appears that the mortgage lending industry would be shouldering a tax increase, while other industries receive a reduction in their tax burden.

The mortgage lending industry is equally concerned that the proposed change in amortization would significantly reduce the value of mortgage servicing as an asset. MBA estimates that the value of mortgage servicing would be reduced by 6 percent. The reduction would occur solely because of the change in amortization.

In addition, changing the amortization of PMSR will increase the cost of housing for low, moderate, and middle income consumers. Mortgage interest rates could increase as much as 12.5 basis points. On first blush, this increase appears small, but it has significant consequences for the typical first-time homebuyer. On a $70,000 mortgage, a typical mortgage for a moderate income borrower, the resulting increase in principal and interest payments would be $75 per year. To meet this additional cost, the borrower will need an additional $500 in yearly income to qualify for the mortgage. If the current amortization remains, a family earning $23,000 could qualify for a $70,000 mortgage. That same family would need $23,500 in income to qualify for the same house, if the 14-year amortization were implemented. This is an unnecessary additional entry barrier for potential homeowners.

Purchased mortage servicing rights are among the best assets regulated financial institutions can hold. PMSRs have a predictable stream of income and are useful portfolio management tools. Given the trend towards increased securitization of mortgages for single and multifamily housing, banking and thrift regulators have concluded that the marketability of servicing will thrive. These assumptions by the regulators will be erroneous if the tax

treatment of mortgage servicing is altered. The reduced marketability of the asset will decrease its value. If PMSR is decreased in value, banks and thrifts will be forced to find new sources to meet core capital and Tier I capital requirements.

Mortgage Revenue Bond (MRB)/Mortgage Credit Certificate (MCC)

MBA supports the Administration's proposal to extend the MRB/MCC program permanently. MBA commends Representative Barbara Kennelly (D-CT) for her sponsorship and hard work to secure a permanent extension of the MRB and MCC programs. These programs are the only remaining Federal programs specifically designed to reduce home mortgage costs for low and moderate income homebuyers. In recent years, the programs have been subjected to a yearly extension and cumbersome recapture rules. MBA urges the Congress to streamline the recapture rules so as to reduce compliance burdens as it extends the program.

Conclusion

MBA supports the Administration's efforts to reduce the deficit by at least 50 percent over the next four years. MBA urges the Committee to incorporate provisions of HR 749 as they affect commercial real estate activity. In addition, MBA strongly opposes adoption of a 14-year amortization of purchased mortgage servicing rights. Including PMSR would add unnecessary costs to consumers as they attempt to buy a home; fundamentally alter an existing competitive market; and increase the tax burden on the mortgage lending industry.

We appreciate the opportunity to testify and will be happy to furnish any needed additional information.

Mr. PAYNE. Before you leave, I want to see if any members have any questions.

Mr. Matsui, do you have any questions?

Mr. MATSUI. No, thank you.

Mr. PAYNE. Mr. Bunning.

Mr. BUNNING. Yes, please.

As you well know, I have been very interested in purchase mortgage servicing rights. In fact, we had some language included in H.R. 11 of last year that would adjust and take care of some of these things, and I heard your testimony, but I want to make sure that I got the exact thing that you were talking about.

In the regulatory capital arena, the OCC, the OTS, the FDIC, and the Fed have all concluded that because PMSR is severable, qualifiable, and marketable, it can be included in the banking institution's regulatory capital. PMSR is the only blanket intangible that can be included in an institution's regulatory capital.

What effect would this provision have on your company? You have generally given us a broad outline, but specifically on your company, what would the provision do?

Mr. TASKER. Well, if this provision were to go through, it would decrease the value of that asset that I use as the core capital of my company, thereby decrease my borrowing power and—with my warehouse banks.

As a mortgage company, I am independent of bankers or a savings and loan—but in the case of bankers or a savings and loan, particularly—some of the savings and loan teetered on the brink of going back, being taken over by the RTC. This would decrease your capitalization and thus make it more likely that they would fail.

So it is definitely an onerous prospect, and we appreciate, Mr. Congressman, your support on this issue and your understanding of it.

Mr. BUNNING. Let me ask you, then, in the $45 billion that the Secretary of the Treasury has said is going to be necessary to finish the job that the RTC is supposed to be finishing, would you say if this were altered that $45 billion might not be enough or might be too little? Would there be more savings and loans that would teeter on the brink?

Mr. TASKER. I would say very definitely this would increase the amount required. It would rise from $45 billion, and I think some of those savings and loans that might now make it would probably in turn fail because of the passage of this.

Mr. BUNNING. In your testimony, you said that purchasing mortgage servicing rights usually have a life of 7 to 10 years. This would extend, obviously, to 14 years in the amortization proposal.

Mr. TASKER. Right. It would extend it, and we would extend an asset we wouldn't have anymore in terms of amortization. This is even more—the 7-to-10-year equation is based on a normal business cycle. For the last 2 years, we have not been in a normal business cycle. We have seen almost a third of the mortgages refinanced out there. So the 7 to 10 years is probably not accurate. It is even too long on that basis. It is probably closer to 5 to 7 years right now.

Mr. BUNNING. Therefore, the capital would deteriorate even further.

Mr. TASKER. Deteriorate even further.
Mr. BUNNING. Thank you very much.
Mr. TASKER. Thank you.
Mr. PAYNE. Other questions of this witness?
Thank you, Mr. Tasker.
It is my understanding that the time of the National Council of State Housing Agencies is being divided between Ms. McFall and Mr. Dwars. Would you all care to proceed?

STATEMENT OF TRUDY P. MCFALL, EXECUTIVE DIRECTOR, MARYLAND COMMUNITY DEVELOPMENT ADMINISTRATION, ON BEHALF OF THE NATIONAL COUNCIL OF STATE HOUSING AGENCIES

Ms. MCFALL. Thank you.

Good afternoon Mr. Chairman, members of the committee. I am Trudy McFall. I am the director of the Maryland Community Development Administration, and I am accompanied, as you noted, by Peter Dwars of the Illinois agency.

I am here to add my voice to the enthusiastic chorus you have already heard for the permanent extension of the Mortgage Revenue Bond Program. My statement is devoted to the urgent need to extend the program as quickly as possible and, most importantly, as you have already heard, this time to make it permanent.

We have been here many times before, and we really need the extension to once and for all be made permanent. The MRB program has been virtually shut down since it expired last June. That is 9 months. And this is causing critical problems for thousands of home owners and low-income people who cannot become home owners. Because of the expiration, the economy has lost thousands of jobs and the Government tens of millions of dollars in revenue. We desperately need MRBs quickly reauthorized and extended permanently.

There are three points I would like to make this afternoon.

First of all, I don't have to tell you because you have heard it directly from many witnesses already. There is broad uniform support for the extension of MRBs and a permanent extension.

President Clinton has asked Congress for permanent MRB extension as part of his economic plan. The House endorsed that plan in the budget resolution last week, and Congress included a permanent MRB extension in the tax bill it passed last fall. President Bush, as we know, vetoed the bill for reasons unrelated to the MRB program.

Bills to make the MRB program permanent were cosponsored by more than 90 percent of Congress last year and have already been cosponsored by nearly a third of the Congress in the less than a month since the bills were introduced.

We ran a coloring book contest that many of you may have seen, and received many touching comments. And we thought one of them—when Hilaria Jiminez of Colorado said that the MRB program meant to her that "even though we have little in life we feel like the richest, highest people just by having our own house." And that is what those of us who run these programs in States feel as we operate the MRB program and help people like this to own homes that they otherwise couldn't.

Second, we want you to remember, as we know you do, that reenacting the MRB program is critical to a strong, sustained housing and economic recovery. MRBs have empowered more than 2 million lower income families to become home owners, 2 million in its history.

MRBs generate jobs. They finance new construction, and they move existing inventory. In 1992, an estimated 27,000 jobs alone came from MRBs and over $750 million in wages. If MRBs are not extended, as many as 37,000 jobs will be lost in 1993 and 60,000 jobs in years thereafter. So MRBs are a very important part of the economic recovery of this country.

Congress has carefully targeted MRB benefits to first-time home buyers of modest incomes through income and purchase price. We think you have enacted good laws, and we are proud of the way that we have implemented them in our State and local governments.

In 1992, for example, the average income of an MRB home buyer nationally was only 74 percent of the national median income. By contrast, the average first-time conventional buyer had an income of $42,000, nearly 45 percent more than the average MRB borrower. In 1992, the average purchase price of an MRB-assisted home was $64,000. Nationally, the purchase price was $100,000. So MRB-financed homes were 56 percent less than conventional homes. We think we are carrying out very clearly your mandate to serve lower income people and enable them to buy modestly priced homes.

Third, Mr. Chairman, MRB's should be permanently extended because they are permanently needed. MRB's are essential in all economic climates. Some say, well, with interest rates low now, maybe you don't need MRBs. Well, now is when MRBs are needed more than ever because this means we can serve even lower-income households to buy homes with the even lower interest rates made possible through the MRB programs.

We would make the MRB program permanent extension our first priority. We are, however, offering in our longer testimony some improvements that we think would help the program: Removing the MRB from the alternative minimum tax, allowing MRB financing for duplexes, allowing a greater level of home improvement, a broader definition of first-time home buyer—some things we think would be very helpful to the program.

We would ask you to look as to whether a fixed private activity bond cap which is not adjusted for inflation over the years is appropriate. Caps for MRBs are used up year after year, and greater volume is needed and would be used.

I want to say in thanking you we know that we are to some degree preaching to the converted with this testimony. Members of this committee have been very supportive and helpful, and we appreciate all that you have done. The State agencies have tried to do their part to help. When the urban aid tax bill, H.R. 11, was imperiled in the Senate last October, we worked tenaciously to rally votes to get it out of the Senate, and we worked to convince the President to sign the bill and worked to the bitter end and mustered all of our resources. We are prepared to do that again to see MRBs permanently extended.

Thank you very much.

Mr. MATSUI [presiding]. Thank you, Ms. McFall.

[The prepared statement follows:]

Testimony Endorsing the President's Proposal to Extend the Mortgage Revenue Bond Program Permanently

House Committee on Ways and Means
March 23, 1993
Trudy P. McFall, Executive Director,
Maryland Community Development Administration
on behalf of the
National Council of State Housing Agencies

Support the President's Plan to Make MRBs Permanent

Mr. Chairman, Representative Archer (R-TX) and members of the Committee, thank you for this opportunity to testify in enthusiastic support of President Clinton's proposals to extend the Mortgage Revenue Bond (MRB) and Low Income Housing Tax Credit (Tax Credit) programs permanently.

This statement is devoted to the urgent need to extend the MRB program as quickly as possible and make it permanent. My colleague, Peter Dwars, Director of the Illinois Housing Development Authority, has provided separate testimony to the Committee on the importance of also quickly enacting a permanent Tax Credit extension.

The MRB program has been shut down since its authorization expired on June 30, 1992, nearly nine months ago. Each month that passes without an MRB extension, thousands of lower income families lose the chance to own their own home and the economy loses thousands of jobs and dollars in tax revenue.

Mr. Chairman, nearly everyone favors a permanent extension for the MRB program. President Clinton has asked Congress for a permanent MRB extension as part of his economic plan -- the first time ever a President has called for a permanent MRB extension. Congress included a permanent MRB extension in the tax bill which it passed and President Bush vetoed last fall for reasons unrelated to the MRB program. Bills to make MRBs permanent were cosponsored by more than 90 percent of the last Congress, and permanent MRB extension bills introduced this year have been cosponsored by nearly one-third of the new Congress in just the 25 days Congress has met since their introduction. The time is now to make this program permanent.

I am Trudy McFall, Director of the Maryland Community Development Administration. I am testifying this morning on behalf of the National Council of State Housing Agencies (NCSHA) and its state housing agency members which administer the MRB program in all but one state.

NCSHA's members are state-chartered, housing finance institutions which finance affordable housing in 48 states, the District of Columbia, Puerto Rico, and the Virgin Islands. During the past two decades, State Housing Finance Agencies (HFAs) have issued over $74 billion in MRBs to finance the home purchases of more than 1.5 million low and moderate income families. HFAs have also issued $26.3 billion in bonds to finance over 500,000 rental apartments for such families.

Since 1987, HFAs in 45 states, the Virgin Islands, and Puerto Rico have helped finance an additional 500,000 apartments for

families with incomes at 60 percent or less of their area's median income using the Tax Credit.

In 27 states, HFAs administer nearly $500 million in new federal HOME Investment Partnership (HOME) funds to support a wide range of affordable housing programs for families who earn 80 percent of their area's median income or less. HFAs collectively administer more than 600 affordable housing programs ranging from homeless to homeownership initiatives.

Through the seven short-term MRB extensions during the last 13 years, HFAs have persevered to make the dream and benefits of homeownership available to American working families who could not otherwise hope to own their own homes. We have worked with this Committee through several program revisions to improve the MRB program and target it increasingly to those families who need the help the most. Today, limited, tested, and perfected, the MRB program is the only federal program exclusively available to reduce mortgage costs for lower income, first-time homebuyers whose incomes are otherwise inadequate to purchase a home.

Another short-term MRB extension would be a tragic setback. The current nearly year-long disruption of the program shows how damaging short-term extensions can be to lower income homebuyers' hopes and dreams. The uncertainty surrounding MRB extensions makes bonds more costly to issue - costs which are ultimately born by the lower income homebuyers whom MRBs are intended to serve. Continual program disruptions force HFAs to time bond issues to survive a sunset rather than to take advantage of the best market conditions.

HFAs should be able to issue when interest rates and homebuyer needs indicate the moment is right, not when a sunset is looming. As Standard & Poor's commented in its December, 1991 issue of Creditweek Municipal, "Generally, sunset provisions create artificial environments in which issuers cannot rely on common sense financial practices but must make their best guess at sizing a bond offering...Forced issuances due to sunset considerations can result in erratic availability of money at a set interest rate."

We stress three points in support of the quick enactment of a permanent MRB extension:

(1) A permanent MRB program is supported by the low income people who depend on the program to buy a home, by the President, by the Congress, by state and local governments, by low income housing advocates, and by the housing industry.

(2) MRBs support the national housing economy. Their re-enactment is critical to a strong and sustained economic recovery.

(3) MRBs are essential in all economic times for lower income families to afford homeownership. In 1992, the average MRB-assisted family had an income of less than 74 percent of the national median income. MRB-financed home prices averaged 64 percent of the national average first-time homebuyer purchase price.

<u>You Have Supported Us and We Have Supported You</u>

We thank you, Chairman Rostenkowski, and the members of this Committee for all you have done to make the MRB program a

permanent part of our federal housing effort. We are especially grateful to Representative Kennelly (D-CT), our chief MRB sponsor, for her leadership in helping obtain a permanent MRB extension from Congress last year. We will continue to rely on all of you for your assistance and support in what we hope will be our last campaign for a permanent MRB program.

When your urban aid tax bill, H.R. 11, was imperiled in the Senate last October, we rallied all the states necessary to supply the Senate votes to defeat the key point of order raised against it and to pass it. We helped form and lead the coalition which waged a campaign to try to convince the President to sign the bill, despite his veto threat. We argued for his signature through our governors, through the press, through personal contact and by every means at our disposal. We did not quit until the day after the election when the President vetoed the bill. We are prepared to do no less to help again this year.

The President and the Congress Support Permanent MRBs

The permanent MRB bill sponsored by Representative Kennelly in the last Congress was cosponsored by 401 House members, including three-quarters of this Committee. Eighty-nine Senators, including three-quarters of the Finance Committee, co-sponsored identical Senate legislation. New legislation, H.R. 462, introduced by Representative Kennelly this year to make MRBs permanent has already been cosponsored by 146 House members, including a majority of this Committee. We urge those members of the Committee who have not yet sponsored this bill to do so as soon as possible.

Even before taking office, President Clinton enthusiastically supported a permanent MRB extension. Both Treasury Secretary Bentsen and HUD Secretary Cisneros have publicly pointed to the permanent MRB extension as one of the cornerstones of the Administration's plan to invest in the rebuilding of America.

Perhaps the most compelling support for the MRB program comes from the children of lower income families who with the help of MRBs were able to buy their first home. NCSHA asked children living in MRB-financed homes to share what their home means to them in drawings and essays. For Sonja Speck of North Carolina, who has moved nine times in 12 years, it means "my first real home." Thirteen-year-old Hilaria Jiminez of Colorado wrote, "Even though we have little in life, we feel like the richest, highest people just by having our own house." And nine year-old Monique Tucker of Nashville, Tennessee wrote, "We could not sit on the porch because children would fight all the time - people shot all the time over there. We own our own house and know we can sit on the porch without anybody bothering us."

A permanent MRB program is supported across the housing community and at all levels of government. A permanent MRB program has been endorsed by the The Enterprise Foundation, the Local Initiatives Support Corporation, the National Low Income Housing Coalition, the National Association of Realtors, the Mortgage Bankers Association of America, the National Association of Home Builders, the National Governors' Association, the National Conference of State Legislatures, the Council of State Community Development Agencies, the U.S. Conference of Mayors, the National League of Cities, the Association of Local Housing Finance Agencies, the National Association of Counties, and the National Community Development Association.

MRBs Support the Housing Economy

MRBs have become a virtual pillar of stability and activity in the housing market. For decades, MRBs have provided mortgages to people who could not otherwise buy a home. MRBs induce new home construction directly, and also indirectly by reducing the inventory of existing homes for sale.

MRBs generate jobs in construction and related industries. Using formulas developed by the National Association of Home Builders (NAHB), we estimate that the MRB loans for newly constructed housing in 1992 produced 27,000 jobs and generated over $750 million in wages and tax revenues. NAHB estimates that if MRBs are not extended, as many as 37,000 jobs will be lost in 1993 and 60,000 jobs will be lost each year thereafter.

MRBs Are Essential In All Economic Times for Lower Income Families

MRBs have empowered more than two million lower income families to become homeowners. In 1991 -- the last full year of the program's operation, 100,000 families purchased their first home with MRB loans and Mortgage Credit Certificates (MCCs) through HFAs. In 1992, when bond issuance was limited to the first six months of the year, 89,000 families were helped with MRBs and MCCs.

MRB assistance makes the crucial difference to America's lower income families' ability to buy a home. In The State of the Nation's Housing 1992, the Joint Center for Housing Studies of Harvard University found that even after recent downtrends in house prices and interest rates, the national homeownership rate is still below its 1980 high of 65.6 percent, dropping from 64.1 percent in 1990 to 64 percent in 1991. The decline is most dramatic for younger households, those most likely to be first-time homebuyers.

The Joint Center also reported that between 1970 and 1991 the real price of a typical starter home rose 17 percent, while the real income of typical first-time homebuyers fell by 12 percent. In addition, while the after-tax cash burden (cost as a percent of income) of homeownership was 31.3 percent in 1990 as compared to 40 percent in 1980-1982, it is still well above the 20 to 25 percent level of the early 1970's. Although the picture has improved marginally, homeownership is still out of reach of most lower income families without the MRB program.

Under the MRB program, HFAs issue tax-exempt bonds and use the proceeds raised from investors to fund mortgages through private lenders to lower income first-time homebuyers who purchase modestly-price homes. MRB loans are made at interest rates as much as 2.5 percent below conventional rates. That means savings of as much as $100 per month on a MRB mortgage, 20 percent of an average monthly mortgage payment. Without the lower monthly payments made possible by MRBs, millions of America's working families -- teachers, firefighters, police officers, industrial, service and agricultural workers -- whose incomes are too low to buy a home and rise more slowly than home prices, may never attain homeownership.

MRB Loans Are Targeted to Those Who Need Them

Congress has carefully targeted MRB benefits to first-time homebuyers of modest incomes through income and purchase price limits established in 1980 and made more stringent since. MRB

loans are available to one or two person households who earn 100 percent or less of the greater of their area or state median income. Larger households may qualify for an MRB loan with incomes up to 115 percent of the greater of their area or state median income.

Congress also strictly limits the purchase price of MRB homes to 90 percent or less of the average area purchase price. A home purchased with MRB financing must be the family's principal residence.

Congress has discouraged the participation of those who could afford to buy conventionally if they just waited longer. To keep such homebuyers from seeking an MRB loan, Congress imposed a recapture penalty in the 1988 Tax Act that requires borrowers whose incomes rise more than 5 percent a year above the MRB income limits to pay the federal government up to 50 percent of the gain realized upon the sale of their house if they resell it within nine years.

Congress has also limited the amount of any MRB issue that can be spent to cover the cost of issuing and selling MRBs to investors, including public hearing expenses, and fees paid to lawyers, accountants, underwriters, trustees, bond rating agencies, and others associated with issuing and selling the bonds.

In practice, most HFAs make loans to families earning much less than the federal MRB income limits for homes priced well below the federal purchase price limits. In 1992, for example, the average income of an MRB homebuyer nationally was only $28,525, 74 percent of the national median income of $38,600. By contrast, the average first-time conventional buyer had an income of $42,300, 110 percent of the national median income, and the average conventional buyer's income was $49,800, 129 percent of the national median. There is a need for the higher federal limits in some high cost and very low income areas, but nationally MRBs are reaching households well below these limits.

In 1992, the average purchase price of an MRB-assisted home was $64,270, compared to a conventional first-time average price of $100,200, and an average of $131,300 for all conventional homes. A chart providing state-by-state 1992 MRB loan, income, and purchase price data is attached to this testimony.

Some have suggested that we no longer need MRBs because interest rates are so low. We are grateful for the relatively low interest rates of the last six months but well remember the unaffordable rates of the last quarter century. We are hopeful rates will remain low but have no reason to believe that higher rates will not return.

Meanwhile low rates and the ability to combine MRBs with other resources just make it possible to reach families of even lower incomes than would otherwise be possible. After mortgage costs, downpayment and closing costs are often the greatest impediment to lower income families in purchasing a first home. Recognizing this, nearly 30 HFAs have combined MRB proceeds with state funds to reduce downpayments and closing costs for homebuyers with limited cash resources, using second mortgages, grants, sweat equity, and flexible borrowing standards. As important as this assistance is, however, the incomes of MRB borrowers are still too low to support a home purchase without monthly mortgage assistance.

MRBs Meet a Multitude of Special Needs

MRBs are the foundation for over 100 innovative programs which respond to diverse public policy concerns. MRBs produce far-reaching benefits to the nation year after year by assisting in urban renewal, bringing mortgage funds into capital-poor areas, and helping the federal government sell its foreclosed housing. MRB funds are set aside for single parents, minorities, veterans, rural areas, inner cities, disaster areas, nonprofits, very low income and disabled individuals, and other special needs.

MRBs Help Revitalize Our Inner Cities

In your state, Mr. Chairman, the Illinois Housing Development Authority is using MRBs to finance its "New Homes for Chicago" program that will produce the first significant new housing to be built in neighborhoods such as West Garfield Park, Austin, and Pilsen in over 75 years. The program is a joint venture with the city, a national mortgage insurer, local home builders, and community development groups.

In a similar venture, the State of New York Mortgage Agency (SONYMA) Project Set-Aside Program allocates funds for 30-year mortgage loans to housing projects under construction in distressed urban areas. Funds are made available to developers, builders, and local community development organizations without commitment or reservation fees. In the last two years, SONYMA has set aside a total of $131 million under this program for 53 projects, which will provide 1,684 affordable units throughout New York. During the last four years, $35 million has been set aside for Harlem projects alone, providing approval for 462 units so far and playing a significant role in the redevelopment of Harlem.

MRBs Move Capital to Areas of Shortage

MRBs represent a major source of mortgage funds for capital-poor rural states and areas. Several states have set aside funds for targeted rural areas, utilizing the capacity of larger urban lenders to assist rural lenders, and combining MRBs with other resources like the Farmers Home Administration (FmHA). The Georgia Housing and Finance Agency (GHFA) was instrumental in using the MRB program to assist FmHA in establishing its new loan guaranty program for rural areas. Using MRB resources, GHFA helped create the secondary market for FmHA guaranteed loans where none had previously existed. As of March 15, 1993, Georgia leads the nation on the dollar amount of FmHA loan guarantees issued--$77 million. The average income of families purchasing under this program is 77 percent of Georgia's statewide median income.

MRBs Support Nonprofit Activity

HFAs are also strengthening the capacity of nonprofit groups and supporting their initiatives, providing MRB loans to lower income buyers of homes constructed by nonprofits. In Maryland, for example, a nonprofit organization combined MRBs with other funding to build new homes for families with incomes as low as $10,000 annually, with payments as low as $259 per month. Similar programs are now operating in California, Connecticut, Georgia, Illinois, Indiana, Minnesota, Montana, Nebraska, Ohio, Oregon, Vermont, and Wisconsin.

The California Housing Finance Agency has developed the "Self-Help Housing Program," which makes MRB commitments to nonprofit housing developers who assist first-time homebuyers in building their own homes. The homebuyer's labor, or sweat equity, constitutes the downpayment on the home. Qualified home building

families are organized into labor-sharing groups, and under the direct supervision of the nonprofit, work as a group to construct their own homes. They then receive a below market rate MRB loan.

MRBs Help People Pull Themselves Up by the Bootstraps

MRBs are being used to help low income renters move out of public and assisted housing into homes of their own. Connecticut HFA's Homeownership '91 program, for example, is moving families out of public and assisted housing by combining MRB financing with financing from the state's Department of Housing to offer mortgage loans at rates as low as 0 percent. So far, 280 families have been able to purchase a home of their own through two rounds of the program. As the families leave public housing, they are being replaced with homeless families. Other states with similar programs to help public and assisted housing tenants become homeowners include Delaware, Michigan, New York, Wyoming, and Virginia.

Further Changes in the MRB Program Should be Considered

Making the MRB program permanent must be our first priority. However, there are aspects of the MRB program that raise rates paid by MRB homebuyers and restrict low income families from participating in the program without any compensating gain to the federal government. Congress could and ought to consider these issues in connection with the budget reconciliation process.

Exempt MRBs from the Minimum Tax

Most financial market experts agree that investors who know that they are subject to the minimum tax avoid purchasing MRBs. These same experts estimate that because purchasers of MRBs worry that they might later become subject to the minimum tax through some change in the tax law or their own financial circumstances, they demand a "higher yield" - about 30 basis points - on their MRB investments than they do on "governmental" purpose bonds (roads, schools, etc.) which are not subject to the minimum tax. HFAs must pass on the higher yield to MRB borrowers, thus increasing their mortgage rate.

Congressional imposition of the minimum tax on MRBs in 1986 has amounted to a punitive measure on MRB borrowers without measurable revenue gain to the government: those who would be subject to the minimum tax if they bought MRBs buy governmental bonds instead; those not subject to the minimum tax buy MRBs, but insist on a 30 basis point yield premium "just in case," which must be paid by MRB borrowers. Congress should exempt MRBs from the minimum tax.

Permit MRB Financing of Two-Family Newly Constructed Homes

MRB financing for two to four family residences is permitted if one of the units is occupied by the owner and the residence was occupied at least five years prior to execution of the mortgage. This precludes the financing of two to four family newly constructed homes.

Duplex homes are common in many older cities where scarce land and high construction costs and property values make multi-unit homes a more cost effective choice for lower income families. In addition, duplexes are an important low-cost option in very poor rural areas. We recommend that the MRB program be amended to permit MRB financing for the purchase of newly constructed two-family homes.

Increase the Limit on MRB-Financed Home Improvement Loans

The current limit of $15,000 imposed in 1981 on MRB home improvement loans no longer reflects today's cost of undertaking home improvements. Since 1981, the U.S. Department of Commerce estimates that the cost of residential rehabilitation has increased approximately 31 percent. Recognizing that its own limit was too low, the Federal Housing Administration (FHA) last year raised the maximum on its Title I insured home improvement loans from $17,500 to $25,000.

MRB home improvement loans help lower income families maintain their homes and preserve the existing housing stock. These loans are limited by law to upgrades in the basic livability, utility, or energy efficiency of the property. The MRB home improvement loan limit should be raised at least to the new FHA limit of $25,000, adjusted upwards for two to four family homes, and indexed for inflation in the future.

Expand the Definition of First-Time Homebuyer

MRB financing is only available to an individual and his or her spouse who have had no ownership interest in their principal residence at any time during the three-year period preceding the execution of their MRB mortgage. This so-called "three-year rule" is waived in targeted areas and for home improvement loans.

For other forms of federal housing assistance, such as HOME funds, the definition of first-time homebuyer has been expanded so as not to exclude any individual who is a displaced homemaker or a single parent who while married owned a home with his or her spouse or resided in a home owned by the spouse. We recommend that the three-year rule be amended to conform with the definition of first-time homebuyer included in section 104 of Title I of the Cranston-Gonzalez National Affordable Housing Act of 1990 (PL 101-625). In addition, we recommend that the three-year rule be waived for families required to move a significant distance to take a new job and for owners of manufactured housing wishing to purchase a permanent home.

Extend First-time Buyer Status to Holders of "Contracts for Deed"

We also recommend that the three-year rule not be applied to very low income families (annual incomes below $15,000 indexed for inflation) who have previously purchased land under a "contract of deed." A contract of deed is a seller-financed contract for the sale of land under which legal title does not pass to the buyer until the final payment is made and for which the penalty for nonpayment is forfeiture of the land rather than judicial foreclosure. The amendment should also allow these very low income families to refinance the land costs in the MRB mortgage. This amendment was included in the two tax bills passed by Congress last year.

Clarify Treatment of Resale Price Control and Subsidy Lien Programs

Both state and local housing finance agencies administer programs in which agency and other state and local funds are used to further reduce the cost of an MRB mortgage (for example, second mortgages to finance closing costs). An amendment is necessary to clarify that subordinate mortgage loans or grants used to finance downpayment and closing cost assistance do not constitute an ownership interest on the part of the lien-holder, the state or local government which made them.

In addition to these issues, Congress should also consider the growing restraints the private activity cap imposes on the MRB program. The present state-by-state volume cap on the issuance of private activity bonds, including MRBs, is the greater of $50 per capita or $150 million annually. This cap was imposed in 1988 and has not been adjusted for inflation since, making it worth 20 percent less in 1993 dollars. Many states, including those where the majority of Americans actually live, exhaust their cap every year and still barely begin to meet the many needs, including housing, which compete for it. The cap should be expanded at least enough to account for inflation over the last five years and be indexed for inflation in future years.

Any and all of these changes are meaningless without an MRB program. Without it, the door to homeownership will be closed for America's lower income families. The time is now to grant the President's request and make the American Dream a permanent hope for all Americans. Enact a permanent MRB extension.

Thank you for this opportunity to testify before you today.

1992 Mortgage Revenue Bond Program

State	Loans Closed (number)	MRB Issuance* (dollars)	Avg. Purchase Price (dollars)	Avg. Borrower Income (dollars)
Alabama	276	101,300,000	60,638	30,363
Alaska	309	45,000,000	104,495	56,926
Arkansas	1,520	101,000,000	43,150	25,404
California	2,073	127,939,542	102,902	35,607
Colorado	1,459	50,000,000	53,798	27,267
Connecticut	1,286	238,250,000	101,286	39,355
Delaware	492	0	80,684	30,859
Dist. of Columbia	110	51,005,000	99,460	36,555
Florida	1,289	301,791,400	62,125	28,174
Georgia	1,165	130,000,000	60,504	27,318
Hawaii	84	0	142,305	40,698
Idaho	2,130	149,365,000	54,013	24,848
Illinois	1,684	136,080,000	68,136	32,514
Indiana	402	82,145,000	51,494	29,648
Iowa	399	139,195,000	49,343	32,016
Kansas	145	47,780,000	41,894	n/a
Kentucky	1,576	55,655,000	44,666	22,577
Louisiana	59	115,862,165	43,789	24,859
Maine	1,193	105,000,000	63,925	27,268
Maryland	2,452	164,370,000	75,745	27,664
Massachusetts	1,338	130,490,000	94,671	32,642
Michigan	1,763	60,000,000	44,486	25,204
Minnesota	2,239	256,925,000	54,097	24,276
Mississippi	378	25,000,000	49,821	26,223
Missouri	2,348	150,000,000	54,800	29,500
Montana	491	47,520,000	48,070	26,020
Nebraska	2,946	125,000,000	47,200	26,000
Nevada	114	25,000,000	83,267	30,332
New Hampshire	1,097	90,000,000	82,175	35,786
New Jersey	1,200	0	108,948	53,424
New Mexico	557	170,755,000	64,700	27,518
New York	3,214	446,000,000	93,232	36,553
North Carolina	1,525	54,815,000	59,206	27,079
North Dakota	919	83,895,000	46,463	27,462
Ohio	3,355	423,995,000	58,843	29,653
Oklahoma	457	30,400,000	42,105	25,838
Oregon	1,092	35,489,785	52,102	24,823
Pennsylvania	4,089	124,800,000	80,482	28,607
Puerto Rico	1,468	120,000,000	50,600	n/a
Rhode Island	2,812	246,155,000	98,251	30,520
South Carolina	567	0	50,600	23,453
South Dakota	1,337	21,495,000	47,181	27,633
Tennessee	1,711	58,455,000	43,085	20,520
Texas	899	132,587,741	48,061	27,530
Utah	1,280	159,260,000	56,071	24,351
Vermont	596	55,000,000	69,659	27,582
Virginia	4,885	888,110,000	73,301	30,748
Virgin Islands	44	0	70,000	33,000
Washington	731	121,370,000	69,567	30,309
West Virginia	1,500	91,300,000	55,000	24,000
Wisconsin	4,537	283,485,000	52,615	28,169
Wyoming	1,186	40,195,330	50,722	28,039
TOTAL	72,579	6,639,335,963	64,270 **	28,525 **

Notes: Total MRB activity does not include MCC issuance. Arizona does not issue MRBs.
*Equals New Money Issues + Current Refundings.
**Totals represent weighted averages based on number of loans.

1992 Mortgage Credit Certificate Program

State	Certificates Issued (number)	Avg. Purchase Price (dollars)	Avg. Borrower Income (dollars)
Alabama	391	74,450	32,418
Arizona	560	70,024	27,570
Colorado	409	60,959	29,280
Hawaii	84	162,777	39,732
Idaho	7	67,518	21,271
Indiana	1,575	62,183	31,421
Iowa	498	51,342	29,276
Kansas	70	50,681	n/a
Massachusetts	334	95,010	33,445
Michigan	2,937	46,638	26,150
Mississippi	68	59,856	25,826
Montana	653	58,827	28,823
New Hampshire	23	85,272	37,554
North Carolina	1,526	69,473	26,874
Oregon	5,728	47,893	23,074
Rhode Island	121	99,662	34,695
Vermont	380	83,755	30,993
West Virginia	498	40,442	26,570
TOTAL	15,862	56,234 *	26,443 *

Note: States not listed above do not issue MCCs.
*Totals represent weighted averages based on number of certificates issued.

Source: NCSHA 1992 Snapshot Survey

Mr. MATSUI. Mr. Dwars.

STATEMENT OF PETER R. DWARS, TREASURER, NATIONAL COUNCIL OF STATE HOUSING AGENCIES, AND DIRECTOR, ILLINOIS HOUSING DEVELOPMENT AUTHORITY

Mr. DWARS. Good afternoon, Mr. Chairman, members of the committee. Thank you for this opportunity to testify in enthusiastic support of President Clinton's proposal to extend the low-income housing tax program permanently.

I am Peter Dwars, director of the Illinois Housing Development Authority and the treasurer of the National Council of State Housing Agencies.

I am testifying on behalf of the NCSHA, whose members allocate the tax credit throughout the country.

The Tax Credit Program has been virtually shut down since its authorization expired last June, nearly 9 months ago. Each passing month, production of nearly 10,000 low-income apartments is lost or delayed. Thousands of low-income families lose the chance to rent safe and affordable housing, and thousands of jobs, millions of dollars of tax revenues, wages and other economic activity are draining away.

We want to thank this committee for all you have done to make the tax credit permanent. We are especially grateful to Chairman Rostenkowski and Congressman Rangel, our chief tax credit sponsors, for your leadership in creating, refining and extending the Tax Credit Program.

I echo Trudy McFall's pledge that we are prepared to do anything we can do to help in passing the reconciliation bill this year.

Like MRB, the permanent Tax Credit Program is supported by nearly everyone. President Clinton has asked Congress for a permanent Tax Credit Program as part of his economic plan. Congress twice passed permanent tax credit extensions last year, but the tax bills containing those extensions were vetoed by President Bush for reasons unrelated to the tax credit.

Nearly 80 percent of the last Congress cosponsored permanent tax credit extension legislation. One quarter of this Congress has already cosponsored the chairman's and Congressman Rangel's new tax credit permanent extension bill, H.R. 18, including a majority of this committee. If you have not sponsored the bill, we urge you to do so now.

A permanent tax credit is also supported by low-income housing advocates, the housing industry, and State and local governments, but the most compelling support comes from the children of low-income families living in the housing made possible by the tax credit.

As Blanca Hernandez, a 10-year-old from Boston, MA, wrote to our group, I especially like to live in Langham Court because where I used to live was a bad neighborhood and drugs were everywhere. A 14-year-old, Jeffrey Stewart, from the same development, says that he can go outside and my parents don't have to be afraid of me getting shot.

Another short-term tax credit extension would be a tragic setback for tens of thousands of families with children such as those. The process of planning, structuring and building of a tax credit

project is complicated, time consuming and expensive. Quality developers cannot be expected to plan tax credit developments without assurance that the program will not suddenly be disrupted by another sunset. Investors are also less willing to purchase tax credits when they are uncertain of the program's future.

Before its disruption last year, the tax credit was the only significant Federal incentive producing low-income housing in the country. Since 1987, the tax credit has helped finance more than 500,000 apartments for low-income families. In fact, it accounted for virtually all of the low-income rental housing construction in the country and about one-third of all apartment construction.

The construction of tax credit projects created an estimated 52,000 jobs just last year. The wages and taxes generated by that activity totaled over $1.6 billion. In 1992, States allocated 70 percent of the $476 million in available tax credits to over 2,000 projects with almost 90,000 low-income units. This production compares with 112,000 low-income units in 1991 when the States had a full year to allocate the per-capita credits.

Precious little credit remains available for allocation. Until a tax credit extension is enacted, just 34 States will have a total of only $92 million available in credits carried forward from 1992. Seventeen States will have nothing to allocate for the balance of the year.

This picture is even bleaker than the numbers suggest. Those States which have no credit left are largely the most populous States. They count for a majority of the tax credit production annually. In 1992, for example, 10 States, including California, New York, Florida, and Illinois, allocated more than 63 percent of all tax credits nationally. A few of those States will receive credit from the national pool, but only $26 million in pool credits will be divided among nine States and will not reach those States until late August or September.

Recently, a Treasury ruling has contributed to the severe credit shortage. The effect of that ruling is to reduce the amount of 1992 unused credits that States may carry forward for allocation in 1993. It is costing 28 States over $41 million in tax credits, $23 million of which will be lost permanently from the program.

In Illinois, we will be losing about $2.3 million in tax credits, and at least $700,000 would have gone to the city of Chicago alone. We now have no credits to allocate until the program is extended.

We would like to thank Chairman Rostenkowski for his recent letter to Secretary Bentsen urging him to reconsider this ruling.

Making the tax credit permanent must be our first priority. However, there are changes that the committee should consider this year. These include amending the carry-forward rule to allow States 24 months to allocate per capita and return credits, permitting the use of the 70 percent credit with HOME funds and tax-exempt bonds, prohibiting discrimination against subsidy holders, applying fair housing requirements, eliminating the application of the minimum tax to the tax credit and relieving passive loss limits on the tax credit investments.

Congress should also consider increasing the $1.25 per capita State limits set forward in adjusting for inflation on a national level.

In the end, Mr. Chairman, this housing production system can only be sustained if Congress accords the tax credit status it has earned as a permanent part of the Tax Code. We look forward to working with you on the changes necessary to make the credit work as efficiently as possible to provide decent and affordable housing for American families.

Mr. MATSUI. Thank you, Mr. Dwars.

[The prepared statement follows:]

Testimony Endorsing the President's Proposal to Extend the Low Income Housing Tax Credit Permanently

March 23, 1993
House Committee on Ways and Means
Peter R. Dwars, Director
Illinois Housing Development Authority
on behalf of the
National Council of State Housing Agencies

Support the President's Plan to Make the Tax Credit Permanent

Mr. Chairman, Representative Archer (R-TX), and members of the Committee, thank you for this opportunity to testify in enthusiastic support of President Clinton's proposals to extend the Low Income Housing Tax Credit (Tax Credit) and Mortgage Revenue Bond (MRB) programs permanently.

This statement is devoted to the urgent need to extend the Tax Credit program as quickly as possible and make it permanent. My colleague, Trudy McFall, Executive Director of the Maryland Community Development Administration, has provided separate testimony to the Committee on the importance of also quickly enacting a permanent MRB extension.

The Tax Credit program has been virtually shut down since its authorization expired June 30, 1992, nearly nine months ago. Each passing month, production of nearly 10,000 low income apartments is lost or delayed, and thousands of low income families lose the chance to rent safe and affordable housing. Thousands of jobs and millions of dollars in tax revenues, wages, and other economic activity generated by apartment construction are draining away.

Mr. Chairman, nearly everyone supports a permanent extension for the Tax Credit program. President Clinton has asked Congress for a permanent Tax Credit program as part of his economic plan--the first time ever a President has proposed a permanent Tax Credit program. Congress twice passed permanent Tax Credit extensions in 1992, but the tax bills containing those extensions were vetoed by the President for reasons unrelated to the Tax Credit. Nearly 80 percent of the last Congress cosponsored permanent Tax Credit extension legislation, and legislation introduced this year to make the Tax Credit permanent has already been cosponsored by more than one-quarter of the new Congress in just the 25 days Congress has met since its introduction. The time is now to make the Tax Credit permanent.

Another short-term Tax Credit extension would be a tragic mistake. The process of planning, structuring, and building a Tax Credit project is complicated, time-consuming, and expensive. Quality private developers and nonprofit organizations cannot be expected to plan Tax Credit projects and devote productive resources to them unless they have assurance that the program will not be suddenly disrupted by a sunset date. Investors are also less willing to purchase Tax Credits when they are uncertain of the program's future. That reduces demand for credits and hence, the amount investors are willing to pay for credits and the equity which can be raised from their sale. The Tax Credit project pipeline has already been seriously disrupted by the program's nearly year-long lapse.

I am Peter R. Dwars, Director of the Illinois Housing Development Authority (IHDA), and Treasurer of the National Council of State Housing Agencies (NCSHA). I am testifying this morning on behalf of NCSHA's member state housing agencies which allocate the Tax Credit in every state, the District of Columbia, Puerto Rico, and the Virgin Islands. Since 1987, these agencies have helped finance over 500,000 apartments for families with incomes at 60 percent or less of their area's median income using the Tax Credit. NCSHA is the principal collector and repository of data on the Tax Credit program, gathering information from our member agencies in annual surveys and sharing this data with Congress, HUD, the Treasury, and the public.

NCSHA's members are state-chartered, housing finance institutions which finance affordable housing in 48 states, the District of Columbia, Puerto Rico, and the Virgin Islands. State Housing Finance Agencies (HFAs) have issued over $74 billion in MRBs to finance the home purchases of more than 1.5 million low and moderate income families. HFAs have also issued $26.3 billion in bonds to finance over 500,000 rental apartments for such families.

In 27 states, HFAs administer nearly $500 million in new federal HOME Investment Partnership (HOME) funds to support a wide range of affordable housing programs for families who earn 80 percent or less of their area's median income. HFAs collectively administer more than 600 affordable housing programs ranging from homeless to homeownership initiatives.

We stress three points in support of the quick enactment of a permanent Tax Credit extension:

(1) A permanent Tax Credit program is supported by the low income families who rely on the program for affordable housing, by the President, by the Congress, by state and local governments, by low income housing advocates, and by the housing industry.

(2) The Tax Credit since 1987 has helped finance more than 500,000 low income rental apartments for families with incomes of 60 percent or less of their area's median income. In fact, it accounts for virtually all low income apartment construction in the country and one-third of all apartment construction. This construction activity supports our housing economy and is critical to a sustained economic recovery.

(3) Before its disruption last year, the Tax Credit was the only significant federal incentive available for the construction and rehabilitation of low income rental housing.

<u>You Have Supported Us and We Have Supported You</u>

We thank Chairman Rostenkowski and the other members of this Committee for all you have done to make the Tax Credit a permanent part of our federal housing effort. We are especially grateful to the Chairman and Representative Rangel (D-NY), our chief Tax Credit sponsors, for their leadership in creating, refining, and extending the Tax Credit program. We will rely on all of you for your assistance and support in what we hope will be our last campaign for a permanent Tax Credit program.

When your urban aid tax bill, H.R. 11, was imperiled in the Senate last October, we rallied all the states necessary to supply the Senate votes to defeat the key point of order against it and pass it. We helped form and lead the coalition which waged a campaign to try to convince the President to sign the bill. We argued for his signature through our governors, through the press, through personal

contact and by every means at our disposal. We did not quit until the day after the election when the President vetoed the bill. We are prepared to do no less to help again this year.

A Permanent Tax Credit is Supported by the President and the Congress

The permanent Tax Credit bill sponsored by Representative Rangel in the last Congress was cosponsored by 332 House members, including more than three-quarters of this Committee. Identical Senate legislation was cosponsored by 86 Senators, including a majority of the Finance Committee.

On February 5, the Chairman and Representative Rangel introduced new legislation, H.R. 18, to make the Tax Credit permanent. That bill already has 112 House cosponsors, including a majority of this Committee. We urge those members of the Committee who have not yet cosponsored that bill to do so as soon as possible.

Even before taking office, President Clinton announced his support for a permanent Tax Credit program. Both Treasury Secretary Bentsen and HUD Secretary Cisneros have publicly pointed to the permanent Tax Credit extension as one of the cornerstones of the Administration's plan to invest in the rebuilding of America.

A permanent Tax Credit program is supported across the housing community and at all levels of government. A permanent Tax Credit has been endorsed by over 50 national organizations, including The Enterprise Foundation, the National Low Income Housing Coalition, the Local Initiatives Support Corporation, the National Association of Realtors, the Mortgage Bankers Association of America, the National Association of Home Builders, the National Governors' Association, the National Conference of State Legislatures, the Council of State Community Development Agencies, the U.S. Conference of Mayors, the National League of Cities, the Association of Local Housing Finance Agencies, the National Association of Counties, and the National Community Development Association.

Earlier this month, mayors from across the country, nonprofit housing organizations, and representatives of major corporate investors in the Tax Credit held a press conference in Washington to ask Congress to extend the Tax Credit permanently. A letter to President Clinton from over 800 community-based housing organizations nationwide asking for a permanent Tax Credit program was released at that press conference.

But perhaps the most compelling support comes from the children of families who have obtained affordable and safe housing made possible by the Tax Credit. Last year, NCSHA sponsored an essay contest for children living in Tax Credit-financed apartments, asking them how they felt about their new homes. Here are just a couple of the responses.

Blanca Hernandez, a ten-year old from Boston, Massachusetts wrote, "I specially like to live in Langham Court because were (sic) I used to live it was a bad neighborhood and drugs everywhere. Here I really don't see no drugs and it's a good neighborhood and I can play outside and I can sleep without worry. Thank you very much for giving me a nice place to live."

For 14-year old Jeffrey Stewart from the same development, it means that he "can go outside and my parents won't be afraid of me getting shot."

Viveka Ayala, a 12-year old from Pawtucket, Rhode Island wrote, "I'd be wandering in the streets, and there'd be a big possibility that I'd use drugs. I wouldn't be going to school. If I was, the kids wouldn't like me and they'd call me names. I'd be alone having no where to go. No family and future."

"My old house had rats, not here at my new house I can sleep better at night and I also feel safer no rats will get on me," wrote Pamela Lowrey, a seven-year old living in Orlando, Florida.

The Tax Credit Is Essential to the Recovery of the Multifamily Construction Industry

Since its enactment seven years ago, the Tax Credit has become an integral part of our nation's housing economy. In 1992, housing units financed by the Tax Credit accounted for over one-third of all rental apartment construction and virtually all low income rental apartment construction. Using data provided by the National Association of Home Builders (NAHB), we estimate that this construction created nearly 52,000 jobs last year. The wages and taxes generated by that activity totaled over $1.6 billion. NAHB estimates that if the Tax Credit is not extended, over 66,000 construction jobs will be lost each year.

Congress created the Tax Credit in 1986 to replace federal tax incentives designed to encourage investment in low income rental housing. With the virtual disappearance of appropriated incentives for low income apartment construction, the Tax Credit is now the only significant federal incentive for low income rental housing construction and rehabilitation at a time when multifamily housing starts are at their lowest level in over 30 years. Though tax-exempt bonds remain available for low income apartment construction, the subsidy they provide is too shallow to support the low-income set-asides they must meet. And restrictions on their use with the Tax Credit, which we address further on in this testimony, have the same effect.

The need for new low income rental housing production predates and has outlived the recession. In fact, the low income apartment production made possible through the Tax Credit barely keeps up with the loss of rental units annually through conversion, abandonment, or demolition. The State of the Nation's Housing 1992, published by the Harvard University Joint Center for Housing Studies, reports that from 1985 to 1990 the housing stock suffered losses of 197,000 rental units each year, including 75,000 low cost units and 15,000 subsidized units.

The Joint Center's report also documents that 77 percent of all poor renters, 3.4 million households, devoted more than half of their incomes to housing in 1989, the last year for which such data is available. Despite such high rent burdens, the study reports that over 25 percent of all poor renters live in structurally inadequate units. Only one-third of all poor renters receive any federal housing assistance.

The Tax Credit Program Is Nearly Shut Down

Demand for Tax Credits in 1992 exceeded supply in many states. Even with the June 30 program cut-off, the overwhelming demand for credit for worthy projects enabled many states to allocate much of the credit available to them in the first half of last year.

In 1992, states allocated 70 percent of the $476 million in available Tax Credits to 2,049 projects with 89,496 low income units. The total $1.25 per capita authority for 1992 was $315 million. This production compares with 112,000 low income units in 1991 when states had a full year to allocate their per capita credits.

Although some unallocated 1992 credits may be carried forward to 1993, precious little credit remains available for allocation. Until a Tax Credit extension is enacted, $319 million in 1993 per capita credits will not be available. In the meantime, 34 states will have a total of only $92 million available in credits carried forward from 1992. In addition, an as yet unknown, but certainly relatively small, amount of credit will be returned to some states from projects that fail to go forward. In late summer or early fall, nine states will receive a total of $26 million from the national pool. Seventeen states will have nothing to allocate for the better part of the year.

The picture is even bleaker than the numbers suggest. Those 17 states that have no credit to allocate without a program extension are largely the most populous states and account for a majority of Tax Credit production annually. For example, in 1992, ten states, including California, New York, Florida, and Illinois, allocated $212 million in Tax Credits, more than 63 percent of all credits allocated nationally. That credit produced 48,371 low income units, more than 50 percent of the low income units produced nationally. A few of those states will receive credits from the national pool. However, only $26 million in pool credits will be available for division among nine states, and that credit will not reach those states until the pool distributions are made in late August or early September.

A recent Treasury ruling (Revenue Ruling 93-18) has contributed to this severe credit shortage. The effect of that ruling is to reduce the amount of 1992 unused credits that states may carry forward for allocation in 1993. It is costing 28 states over $41 million in Tax Credits, $23 million of which will be lost permanently from the program. NCSHA is urging the Treasury to rescind this ruling.

The Treasury is taking the position that 1992 carryforward credits are only available to a state in 1993 if its total 1992 allocation was less than the sum of its 1992 per capita and returned credits. If a state's total allocation was less than this sum but it allocated either 1991 carryforward or 1992 pool credits in the second half of the year, the state's 1992 carryforward is be reduced by the amount of that allocation.

The Treasury believes this outcome is unavoidable under the so-called "stacking rule," which requires that states first allocate their per capita and returned credits before allocating their carryforward or pool credits. This interpretation, however, ignores the fact that per capita credits could not be allocated after the June 30 program sunset, and at the time, states were advised by Treasury that they could allocate carryforward and pool credits.

The Treasury ruling is costing my state of Illinois over $2.3 million in Tax Credits. It means that Illinois will have no credits to allocate until the program is extended, which probably will not be until June under the best of circumstances. Ironically, Illinois allocated all of our per capita authority prior to June 30, and all of our 1991 carryforward by year-end. But because 1992 per capita credits came back to the state in the second half of the year and could not be reallocated because of the program sunset, we are now losing that amount of credit. A number of other states are in the same position. We allocated all the credit we could, when we could, and we are being penalized.

We thank you, Mr. Chairman, for your recent letter to Treasury Secretary Bentsen urging him to reconsider this ruling. Seven members of the Senate Finance Committee from affected states, including Majority Leader Mitchell (D-ME) and Minority Leader Dole (R-KS), have also asked Secretary Bentsen to reconsider his position.

This serious situation only underscores that the stacking rule does not work. Congress recognized this last year when it efffectively reversed, with the Treasury's support, the stacking rule in tax legislation vetoed by the President. We ask you again this year to amend the Tax Credit program to allow states 24 months to allocate per capita and returned credits as Congress intended when it authorized the carryforward provision in the 1990 Tax Act.

The Tax Credit is Meeting Challenging State Housing Needs

Illinois has successfully used the Tax Credit program to address a broad range of housing needs in our state. IHDA has allocated $49 million in Tax Credits since 1987 assisting nearly 13,000 low income families.

In 1989, the Washington Courts Project in Chairman Rostenkowski's district was completed. The project was developed by City Lands Corporation, a nonprofit subsidiary of the SouthShore Bank Corporation, the model for President Clinton's national community development bank proposal. This 103-unit project contains a mixture of one, two and three bedroom units, and all families receive Section 8 subsidies from HUD. The project is the cornerstone for revitalization of the neighborhood.

Other states have similar success stories. The Texas Department of Housing and Community Affairs worked with a nonprofit sponsor in Dallas to develop Hillcrest House, a 65-unit Single Room Occupancy (SRO) development housing persons afflicted with AIDS. The project is receiving additional financing from commercial banks and the City of Dallas' Community Development Block Grant (CDBG) program. Resources to provide care and services for the residents will come from HUD's new Shelter Plus Care program.

New York has allocated Tax Credits to projects to fund social service costs. Under the Permanent Housing for Homeless Families Program (PHHP), the New York Housing Finance Agency oversees the construction and rehabilitation of projects which will provide permanent housing for homeless families and those at risk of homelessness. Currently, six of the PHHP sites have an allocation of Tax Credits, three of which are in Representative Rangel's district. HELP-Homes, the largest of the PHHP projects includes 150 units and a 25,000 square foot community center. Tax Credit proceeds will be used to staff this center and provide a variety of support services.

Representative Payne (D-VA) personally attended the opening of Maple Manor, located in Chase City, Virginia. In this project, the developer converted a former high school into 26 units for elderly persons in desperate need of affordable rental housing. All of the units will serve households with incomes below 60 percent of the area's median income. The project receives an annual allocation of $33,000 in Tax Credits as well as Historic Rehabilitation Tax Credits, a loan from the Farmers Home Administration (FmHA), and an energy grant from the Virginia Housing Partnership.

Refinements to the Tax Credit Program Should be Considered

The success of the Tax Credit is due in large part to the important improvements Congress has made to the program since 1987. NCSHA's members are grateful to have had the opportunity to help this Committee craft these reforms. These improvements, along with fine-tuning by HFAs of their Tax Credit programs and increased competition among developers for Tax Credits, have made for a more efficient program.

HFAs have effectively implemented the Congressional mandate in the 1989 Tax Act to evaluate proposed projects to assure that each receives the minimum amount of Tax Credit needed for feasibility and long-term viability as a low income housing development. This evaluation considers all sources and amounts of financing, including other federal, state, or local subsidies and syndication proceeds. State allocation plans ensure that the Tax Credit is allocated in accordance with states' housing needs. In addition, HFAs now monitor Tax Credit projects for compliance with the program's low income occupancy requirements.

Making the Tax Credit permanent must be our first priority. However, there are some changes that the Committee could and ought to consider in connection with the budget reconciliation process.

Adjust the Carryforward Rule So It Works As Congress Intended

Each state receives an annual Tax Credit allocation of $1.25 per resident ("per capita" credits). In the 1990 Tax Act, states were given the authority to carry forward their unused per capita and returned Tax Credits for allocation in the next calendar year. Any Tax Credits carried forward but not used by the end of the second year are lost to the national pool and redistributed to qualified states. Qualified states are those which use all their available credit in the prior year. Before the carryforward provision, states were required to use all per capita and returned credits within the calendar year or lose them. There was no national pool.

The purpose of the carryforward change was to give states 24 months to allocate their per capita and returned Tax Credits and remove the "use it or lose it" pressure states felt at year-end. However, due to the way the provision was drafted, states must use all of their per capita and returned Tax Credits before they can allocate carryforward or pool credit.

The result is that states must use all per capita and returned credits to avoid the loss of carryforward credits to the national pool or pool credits from the program altogether. In doing this, they lose the opportunity to carry forward those credits. This effectively creates an every-other-year carryforward and does not give states a full 24 months to allocate their per capita and returned credits as Congress intended. The Tax Credit should be amended to allow states to allocate their carryforward or pool credits first.

Return Unallocated Pool Credits to the National Pool

If a state does not allocate credits it receives from the national pool, those credits are lost from the program. Most pool states, however, face demand for Tax Credits that far exceeds even the additional amount they receive from the pool. In such an environment, not a dollar of credit should be lost.

The Tax Credit program should be amended to provide that pool credits not allocated by the end of the allocation year are put back in the pool for reallocation the following year.

Permit Use of the 70 Percent Credit With HOME Funds and Tax-Exempt Bond Proceeds

Under current law, Tax Credit projects utilizing HOME funds or tax-exempt bond proceeds are limited to the 30 percent, rather than the 70 percent, present value credit. This limit was included in the original Tax Credit statute before states were required to underwrite Tax Credit projects to ensure that they receive only the amount of subsidy necessary to their feasibility and long-term viability. States should now be allowed to determine the appropriate amount of credit to allocate with HOME funds and tax-exempt bonds through proven underwriting practices just as they make this determination for other projects. Congress demonstrated its confidence in the states' Tax Credit administration when last year it delegated to them responsibility for conducting the HUD subsidy layering review process for Tax Credit projects which receive HUD subsidies.

Limiting HOME projects to the 30 percent credit is also inconsistent with the treatment of CDBG funds combined with the Tax Credit. Recognizing the essentially "local" character of CDBG, Congress clarified in the 1990 Tax Act that up to the 70 percent credit could be used with CDBG. The rationale was that CDBG is a block grant under which funds are distributed by formula to states and local jurisdictions which determine how the funds are used. Because funding decisions are made at the state and local level and not by HUD, the funds lose their "federal" character.

Since that change, the HOME program was authorized in the Cranston-Gonzalez National Affordable Housing Act of 1990. HOME works much like CDBG. HOME funds are distributed to state and local governments to be used at their discretion to meet their unique needs through a wide array of housing activities.

The ability to use Tax Credits with HOME funds and tax-exempt bond proceeds is particularly important today because of the "credit crunch." Developers, both nonprofit and for profit, are finding it increasingly difficult to secure mortgage financing for Tax Credit projects. Use of the full Tax Credit in combination with tax-exempt bond financed mortgages and HOME subsidies can help alleviate this problem.

Allow Election to Determine Rent Limitation Based on Unit Size

Prior to 1989, Tax Credit unit rents were determined by the size of the family inhabiting the unit. To ease administration of Tax Credit projects, the 1989 Omnibus Budget Reconciliation Act permitted owners of future projects to determine rents based on unit size. However, this change was not made retroactive to existing projects.

The Tax Credit should be amended to allow owners of pre-1990 projects to make a one-time election to have the 1989 amendment apply to such projects but only with respect to tenants first occupying any unit in the building after the date of the election. Such an election could be made only during the 180-day period beginning on the date of enactment. Once made, the election would be irrevocable.

Waive the "Anti-Churning" Rule for 221(d)(4) Projects

Projects substantially assisted, financed, or operated under Section 221(d)(4) of the National Housing Act are not eligible for the Tax Credit if they were placed in service within the past ten years. These projects were unintentionally left out of the waiver granted to other HUD-assisted projects in the 1989 tax bill which was

recommended in the 1988 Mitchell-Danforth Task Force report. The Tax Credit's ten-year anti-churning rule should be waived for 221(d)(4) projects.

Clarify Rules on Student Tenancy

Currently, full-time students may not reside in a Tax Credit unit unless they are dependent minors of the primary tenant or eligible for AFDC benefits. Although this provision was originally intended to prevent dependent college students from renting low income units, it also has the effect of excluding low income, single parent families in which the parent is enrolled in school. A unit occupied solely by full-time students should qualify for the Tax Credit if the full-time students are a parent and his or her minor children and the tenants are not dependents of a third party.

Allow for de minimis Errors in Low Income Set-Aside

Owners of Tax Credit projects can have credit recaptured if they incorrectly determine the proper set-aside of low income units in a project, even if the error results in only one unit being misclassified. The Treasury should be authorized to grant a waiver of penalties for de minimis errors in the application of low income tenant set-aside rules.

Allow for de minimis Exception for National Pool Qualification

States may not qualify to receive allocations from the national pool of unused Tax Credits unless they exhaust all credit available from their ceiling for the preceding year. However, undetected accounting errors, credits returned at the end of the year, or an amount of credit remaining which is too small to allocate to a project could invalidate a state's participation in the pool despite their good faith efforts to allocate all of their available credit. The Treasury should be authorized to grant national pool qualification to states which retain a de minimis amount of their total credit.

Prohibit Discrimination Against Subsidy Holders

To ensure that prospective tenants holding Section 8 subsidies are not refused units in privately-owned low income housing projects, most federal housing programs carry a prohibition on discrimination against certificate and voucher holders. The Tax Credit program should be amended to prohibit discrimination against holders of rental subsidies.

Implement Fair Housing Requirements

Some have questioned whether Tax Credit projects are housing minority tenants. We have no data that suggests they are not. However, we believe that Tax Credit projects should be subject to the same fair housing requirements as other assisted housing.

The Tax Credit program should be amended to require that Tax Credit project owners certify that their developments are administered in conformity with Title VI of the Civil Rights Act of 1964 and the Fair Housing Act. In addition, state allocating agencies should require owners to develop an Affirmative Fair Housing Marketing Plan in accordance with related HUD regulations.

Eliminate Application of the Minimum Tax to the Tax Credit

The Alternative Minimum Tax (AMT) reduces the number of Tax Credit units financed because investors demand a greater rate of return on their Tax Credit investments than if AMT did not need to be paid. To that extent, relatively more credits must be sold to

produce a Tax Credit unit than if AMT did not apply. Any government revenue gain from AMT on the Tax Credit is at least fully offset by a reduction in the number of apartments financed at any given level of Tax Credit allocation. For that reason, individuals should be allowed to use Tax Credits to offset AMT liability to the extent of the lesser of $20,000 or 25 percent of AMT liability.

Relieve Passive Loss Limits on Tax Credit Investments

The passive loss limits on individuals severely limit - to about $7,750 - the amount of Tax Credits any individual can use to offset income annually. The effect of this provision is to create a kind of monopoly marketplace for Tax Credit sales to corporations, which are not subject to passive loss limits. Those corporations are sophisticated in finance and demand a significantly higher rate of return on their Tax Credit investments than individual investors do, thus reducing the number of units which can be produced. Expanding the market of Tax Credit syndication to more private investors will increase demand for the Credit and raise the yield in equity derived for Tax Credit projects. The rules governing losses on passive business investment should be amended to allow individuals to utilize Tax Credits to offset $20,000 of regular tax on non-passive income.

Expand Tax Credit Authority

The annual allocation of Tax Credits available to each state is equal to $1.25 per capita. This limit was set in 1986 and has not been adjusted for inflation since. Demand for the Tax Credit now outstrips supply in many states. Last year, 20 states, representing over 50 percent of the total per capita Tax Credit volume nationwide, received additional authority from the national pool of unused Tax Credits because they exhausted all their available credits the previous year. Unfortunately, this pool will never be large enough to meet the demand of the states in greatest need. Annual Tax Credit authority should be expanded, at least for those states which exhaust their current credit authority each year.

Some have suggested additional modifications to the Tax Credit program such as targeting the program to very low income families and extending the low income use restrictions on Tax Credit projects. While we share these concerns that long-term affordable housing for households in greatest need should be a priority, further restrictions on the Tax Credit program without the assurance of the additional subsidies necessary to meet those restrictions would be counterproductive.

The Tax Credit was not designed to provide a deep enough subsidy to serve the lowest income households without additional subsidies. On its own, the Tax Credit is designed to finance projects in which 20 percent of the units serve households at 50 percent of median income or less or projects in which 40 percent of the units serve households at 60 percent of median or less. Nonetheless in 1989, Congress mandated that state Tax Credit allocating agencies "give preference to projects serving the lowest income tenants" (Section 42(m)(1)(B)(ii)), and through the use of state resources and other federal subsidies, states have gone far beyond the targeting in the law. Virtually every Tax Credit project financed today has 100 percent of its units serving households below 60 percent of median income, and many units are serving families well below that level.

States do their best to meet that mandate within the constraints of the depth of the Tax Credit subsidy. Last year, the Florida State Auditor General conducted a survey of the state's Tax Credit projects. The report shows that the median income of a Tax Credit household in the state of Florida was $9,360, 26 percent of

the states' median income. Households with children had an annual median income of $8,363. Overall, 90 percent of the households residing in Tax Credit units had incomes below $17,950, 50 percent of the state's median income.

States like Florida achieve these results because they can combine the Tax Credit with state funds and additional federal subsidies, such as Section 8 rental assistance. Many states cannot provide the same level of assistance. There is no guarantee that Section 8, a direct federal appropriation, will be available for every Tax Credit household who requires it. In fact, the House has passed a budget resolution which will freeze domestic discretionary spending for the next five years, making it even more difficult to provide rental assistance for new households. Until sufficient subsidies are available to augment the Tax Credit program, deeper income targeting will simply cause fewer units to be produced.

We have similar concerns about a proposal to extend the low income use restrictions on Tax Credit projects. Under current law, most projects must remain affordable for 30 years. As with income targeting, Congress has required states to "give preference to projects serving qualified tenants for the longest periods" (Section 42(m)(1)(B)(ii)) and many states have gone beyond what is required by statute. For example, California now requires 55-year low income use on its Tax Credit projects, and for New York projects which combine Tax Credits with the state's "Turnkey" program, a 99-year low income use restriction is required. In order to entice developers to build projects with such long-term affordability covenants, states must offer incentives beyond the allocation of Tax Credits. Without the assurance of additional subsidies, mandating longer-term affordability is meaningless.

The importance of the Tax Credit is especially clear in light of the sharp curtailment in direct federal expenditures for new units of low income rental housing. In 1980, 80 percent of federal housing expenditures were allocated to adding new units to the stock of assisted housing. Conversely, in 1992 only 20 percent of all federal housing funds provided new units, with the remaining 80 percent necessary just to keep the existing inventory in place.

In the end, Mr. Chairman, this effective housing production system can only be sustained if Congress accords the Tax Credit the status it has earned as a permanent part of the Tax Code. We look forward to working with the Committee on any changes necessary to make the Tax Credit work as efficiently as possible to provide decent, affordable housing for low income American families who need it.

Thank you for the opportunity to testify today.

1992 Low Income Housing Tax Credit Program

State	Per Capita Credits (dollars)	Total 1992 Credits † (dollars)	Total Allocations (dollars)	Total Units (number)
Alabama	5,111,250	9,752,062	1,045,647	545
Alaska	712,500	1,139,679	940,122	141
Arizona	4,687,500	5,285,618	3,015,340	877
Arkansas	2,965,000	3,029,302	1,720,733	824
California	37,975,000	64,261,202	64,017,031	8,601
Colorado	4,221,250	5,485,547	4,401,271	1,207
Connecticut	4,113,750	5,231,555	1,173,111	398
Delaware	850,000	1,192,296	1,192,296	321
D.C.	747,500	1,274,087	0	0
Florida	16,596,250	25,629,608	25,629,608	7,806
Georgia	8,278,750	10,590,593	5,396,260	4,132
Hawaii	1,418,750	1,507,904	1,498,989	192
Idaho	1,298,750	1,913,139	1,711,297	524
Illinois *	14,428,750	18,957,499	16,591,343	4,077
Indiana	7,012,500	8,224,340	6,870,861	1,753
Iowa	3,493,750	3,497,166	3,015,401	1,546
Kansas	3,118,750	4,366,931	2,749,206	1,015
Kentucky	4,641,250	6,525,544	5,487,051	1,843
Louisiana	5,315,000	5,315,000	1,730,126	1,207
Maine	1,543,750	2,389,957	846,207	580
Maryland	6,075,000	11,098,195	5,627,290	1,347
Massachusetts	7,495,000	13,609,461	8,975,096	1,628
Michigan	11,710,000	15,526,213	5,917,893	1,907
Minnesota	5,540,000	7,908,673	6,114,016	2,239
Mississippi	3,240,000	3,551,829	980,973	745
Missouri	6,447,500	9,402,235	3,255,313	977
Montana	1,010,000	1,861,386	1,379,731	370
Nebraska	1,991,250	3,416,562	2,397,184	740
Nevada	1,605,000	2,572,861	2,572,861	508
New Hampshire	1,381,250	2,647,824	182,314	88
New Jersey	9,700,000	11,139,560	9,204,058	1,412
New Mexico	1,935,000	3,043,682	1,347,813	546
New York	22,572,500	38,727,802	38,727,802	4,353
North Carolina	8,421,250	12,593,108	6,225,502	2,205
North Dakota	793,750	1,113,394	1,104,249	354
Ohio	13,673,750	22,804,160	12,998,258	3,860
Oklahoma	3,968,750	5,754,480	2,290,292	2,862
Oregon	3,652,500	5,123,367	5,123,367	1,131
Pennsylvania	14,951,250	28,816,428	9,006,070	2,025
Rhode Island	1,255,000	1,968,188	977,083	341
South Carolina	4,450,000	6,893,074	4,675,291	1,794
South Dakota	878,750	959,907	854,666	410
Tennessee	6,191,250	9,338,708	1,869,725	1,092
Texas	21,686,250	27,230,794	15,458,223	11,930
Utah	2,212,500	4,564,136	4,564,136	1,524
Vermont	708,750	1,018,331	807,577	341
Virginia	7,857,500	12,889,887	10,685,797	3,057
Washington	6,272,500	10,122,567	9,903,473	1,536
West Virginia	2,251,250	4,209,153	710,830	426
Wisconsin	6,193,750	10,506,064	9,591,791	2,460
Wyoming	575,000	832,209	173,790	147
TOTAL	315,226,250	476,813,267	332,734,364	91,944

Note: Total activity does not include projects financed with tax-exempt bonds, which are not subject to state allocation limits and resulted in relatively few additional Credits in 1992.

† Equals Per Capita + Returned + Carryover + National Pool Credit Authority.

* Includes activity from City of Chicago Department of Housing.

Source: NCSHA 1992 Snapshot Survey.

Mr. MATSUI. I would just caution all the witnesses that we would like to maintain a 5-minute rule since we do have a number of additional witnesses. We do appreciate your testimony and the testimony of all other witnesses.

Mr. Wechsler.

STATEMENT OF STEVEN A. WECHSLER, PRESIDENT, NATIONAL REALTY COMMITTEE

Mr. WECHSLER. Thank you.

Mr. Chairman, members of the committee, good afternoon. My name is Steven Wechsler, and I am president of the National Realty Committee.

NRC serves as real estate's roundtable in Washington on national issues affecting real estate. Our members are America's leading commercial and multifamily real estate owners, advisers, builders, lenders, investors, and managers.

Our message today is simple and straightforward: Long-term rational tax policy initiatives along the lines approved by Congress last year are needed and needed now if today's still volatile commercial real estate markets are to stabilize and if our Nation's prospects for long-term economic recovery and growth are to strengthen.

Real estate's role in our Nation's economy is significant. Real estate generates over one-fifth of our Nation's GNP, over two-thirds of the tax revenues relied upon by localities for essential services, and well over 8 million jobs. It is because of this significant economic role that when real estate is in crisis, as it is today, a heavy toll is extracted from our national economy.

Commercial real estate values have fallen dramatically—by over $500 billion so far in the 1990's—and commercial real estate markets remain illiquid and essentially dysfunctional. And unless and until real estate markets stabilize, the economy will be held back.

As a result of this crisis, the tax bases of America's cities erode. In addition, the growth of all businesses that rely on real estate as collateral for commercial and industrial loans is inhibited, and financial institutions are subject to added risk.

Last year, members of this committee and Congress passed legislation that included a number of constructive real estate initiatives to address this crisis. For the leadership of Chairman Rostenkowski on these issues and for the leadership of Representatives Andrews, Thomas, Mr. Matsui yourself, Mr. Shaw and many of the others on this committee, NRC and the rest of the real estate community offers its thanks. From our perspective, it is unfortunate that last year's tax bill was not signed into law.

Fortunately, significant portions of H.R. 11's real estate provisions on passive losses, pension investment and low-income housing have been included in President Clinton's economic plan. The administration's plan is responsive to the problem and is a very welcome step forward. It is our hope that this plan will serve as the building block for this committee and Congress to fully address the real estate crisis and thereby set the national economy on track for sustained economic recovery.

From NRC's point of view, it is critical that Congress pass H.R. 749, legislation sponsored by over two-thirds of this committee that

include H.R. 11's provisions on passive losses, debt restructuring and pension investment in real estate. Equally critical is modification of the tax treatment of the leasehold improvements.

Importantly, these four initiatives make sense for the long term, and they will neither encourage speculative development nor lead to tax-motivated tractions.

Specifically here is our prescription:

First, the passive loss rules should be reformed. As this committee has noted in the past, the current rules discriminate against people in the real estate business. Consistent with the committee's action last year, these rules should be changed to treat people in the real estate business the same as everyone else.

Our view is the solution offered in H.R. 11 and restated in H.R. 749 is the right answer. The administration's plan takes an important first step by extending equal treatment to real estate income. But, as Congress agreed to last year, we believe true equal treatment can only be achieved by applying the new rules to all income.

Second, obstacles to prudent pension investment in real estate should be removed. The committee has noted in the past that there are several UBIT and REIT rules that, in effect, unjustifiably penalize pension investment in real estate. H.R. 11 would have removed several of these penalties. So would the administration's plan.

Additionally, H.R. 749, like H.R. 11, includes a provision that would remove the penalty associated with domestic pension fund investment through REIT's. This initiative originated in this committee, and it is our hope it will be added again this year.

Third, the tax treatment of the debt restructuring and workouts should be rationalized. Today, restructuring commercial real estate debt results in immediate taxation even though no cash income is generated. Surprisingly, the tax is often lower if the taxpayer deeds the property back to the lender or goes into bankruptcy. Like H.R. 11, H.R. 749 includes an initiative that would reform the rules in this area. We wholeheartedly encourage Congress to adopt this provision again this year.

Finally, the tax treatment of leasehold improvements should be modified. What are they? Simply stated, they are what make an office an office: Internal walls, ceilings, partitions, plumbing, lights, and finish.

When the owner of rental property reconfigures space to suit the needs of the tenant, the owner is required to depreciate these tenant improvements over 31½ years even though the life of these improvements typically corresponds to the life of the tenant's lease, on average about 10 years.

We believe rational tax policy dictates that the recovery period for these internal improvements should reflect economic reality.

Taken together, these four measures represent the kind of balanced, rational tax policies that should serve the economy well over the long term.

Mr. Chairman, the balance of my written statement provides a detailed explanation of the provisions contained in H.R. 749 and the reasons why the cost recovery rules for leasehold improvements should be rationalized.

Thank you.

Mr. MATSUI. Thank you, Mr. Wechsler.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL REALTY COMMITTEE TO THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES REGARDING THE PRESIDENT'S PROPOSAL FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

Steven A. Wechsler
President
National Realty Committee

March 23, 1993

Mr. Chairman, members of the Ways and Means Committee, good afternoon. My name is Steven A. Wechsler, and I am president of National Realty Committee.

As many of you know, NRC serves as Real Estate's Roundtable in Washington on national issues affecting real estate. Our members are America's leading commercial and multifamily real estate owners, advisors, builders, investors, lenders and managers.

Our message today is simple and straight-forward: long-term, rational tax policy initiatives along the lines approved by Congress last year are needed -- and needed now -- if today's still volatile commercial real estate markets are to stabilize, and if our nation's prospects for long-term economic recovery and growth are to strengthen.

As the past several years have illustrated, real estate's role in our nation's economy is significant. After all, real estate generates over one-fifth of our nation's GNP, over two-thirds of the tax revenues relied upon by localities for essential services, and well over eight million jobs.

It's because of this significant economic role that when real estate is in crisis, as it remains today, a heavy toll is extracted from our national economy.

Commercial real estate values have fallen dramatically -- by over $500 billion so far in the 1990's -- and commercial real estate markets remain illiquid and essentially dysfunctional. Unless and until real estate markets stabilize, the economy will be held back . . . hard-pressed to sustain long-term economic growth.

As a result of this crisis, the tax bases of America's cities erode. In New York City alone, the third annual decline in real estate assessments will mean $350 million less in property tax revenues in the coming year.

In addition, the growth of all businesses that rely on real estate as collateral for commercial and industrial loans is inhibited. Further, financial institutions, which hold over $800 billion of commercial and multifamily real estate loans, are subject to added risk.

Last year members of this Committee and the Congress passed legislation that included a number of constructive real estate initiatives to address this crisis -- a crisis caused in large part by ill-conceived national policies, oversupply, national recession, and a radically changed marketplace.

For your leadership on these issues, Chairman Rostenkowski, and for the leadership of Representatives Andrews, Thomas, Matsui, Shaw and many others on this Committee, NRC and the rest of the real estate community offer its thanks. From our perspective, it's unfortunate that last year's tax bill, H.R.11, was not signed into law.

Fortunately, significant portions of H.R.11's real estate provisions on passive losses, pension investment and low-income housing have been included in President Clinton's economic plan. The Administration's plan is responsive to the problem and is a very welcome step forward.

It is our hope that this plan will serve as the building block for this Committee and Congress to fully address the real estate crisis and thereby set the national economy on track for sustained economic recovery.

From NRC's point of view, it's critical that Congress pass H.R.749 -- legislation that includes H.R.11's provisions on passive losses, debt restructuring and pension investment in real estate. Equally critical is the modification of the tax treatment of leasehold improvements.

Importantly, these four real estate initiatives make sense for the long-term -- and they will neither encourage speculative development nor lead to tax-motivated transactions.

Specifically, here's our prescription for addressing the real estate crisis:

First, the passive loss rules should be reformed. As this Committee has noted in the past, the current passive loss rules discriminate against people in the real estate business. Consistent with the Committee's action last year, these rules should be changed to treat people in the real estate business the same as everyone else -- that is, no better or no worse, just provided the same, equal treatment.

Our view is that the solution offered last year in H.R.11 and restated this year in H.R.749 is the right answer, because it in fact provides equal treatment under the passive loss rules to most people in the real estate business. It also would help stabilize property values nationwide and encourage building owners to hold troubled properties rather than deed them back to lenders.

The Administration's plan takes an important first step by extending equal treatment to real estate income. But we, as Congress agreed to last year, believe true equal treatment can only be achieved by applying the new rules to all income.

Second, obstacles to prudent pension investment in real estate should be removed. This Committee has noted in the past that there are several unrelated business income tax rules (UBIT) and real estate investment trust (REIT) rules that in effect unjustifiably penalize pension investment in real estate.

H.R.11 would have removed several of these penalties. So would the Clinton plan. Additionally, H.R.11, as well as H.R.749, included a provision that would remove the penalty associated with domestic pension fund investment through REITs. This initiative originated here in this Committee, and it's our hope it will be part of comprehensive tax legislation again this year.

Third, the tax treatment of debt restructurings and workouts should be rationalized. Today, restructuring commercial real estate debt results in immediate taxation, even though no cash income is generated. Surprisingly, the tax is often lower if the taxpayer deeds the property back to the lender or goes into bankruptcy.

Like H.R.11, H.R.749 includes an initiative that would reform the rules in this area to reduce the number of unnecessary bankruptcies, facilitate loan workouts and ease pressure on financial institutions. We wholeheartedly encourage Congress to adopt this provision again this year. In fact, no single initiative could do more to ease the gridlock between lenders and borrowers.

Finally, the tax treatment of leasehold, or tenant, improvements should be modified. What are tenant improvements? Simply stated, they're what make an office an office: internal walls, ceilings, partitions, plumbing, lighting and finish.

When the owner of a rental property reconfigures space to suit the needs of a tenant, the owner is required to depreciate these tenant improvements over 31-1/2 years, even though the life of these improvements typically corresponds to the life of the tenant's lease, on average about 10 years.

We believe rational tax policy dictates that the recovery period for these tenant improvements should reflect their useful lives, generally the life of the lease-term. Especially given proposals to increase the depreciation period for nonresidential buildings -- including tenant improvements -- now is an opportune time to revisit these rules.

In summary, what is needed is constructive action on these four issues -- passive loss reform, pension investment, debt restructuring and leasehold improvements.

Taken together, these measures -- three of which are contained in H.R.749 -- represent the kind of balanced, rational tax policies that should serve the economy well over the *long-term*. That they have the added benefit in today's world of helping to stabilize real estate and foster economic growth is all the more reason to enact them now.

For your information, Mr. Chairman, what follows is a more detailed explanation of the provisions contained in H.R.749, and the reasons why the cost recovery rules for leasehold improvements should be rationalized.

The Real Estate Stability and Recovery Act of 1993 -- H.R.749*

This legislation proposes three initiatives to help stabilize real estate values and restore liquidity to real estate markets, thereby helping provide a foundation for long-term economic growth. The proposals contained in H.R.749 received significant review, analysis and modification by members of the Congressional tax-writing committees and their staffs during 1992. Each proposal was approved by Congress in 1992, but vetoed for unrelated reasons, and we strongly urge that these provisions be included in the tax legislation the Ways and Means Committee soon will begin to fashion.

Passive Loss Modification

H.R.749 would modify the passive loss rules to allow individuals in the real estate business to be treated the same as individuals in other lines of business. This provision is needed because the current passive loss rules discourage owners from holding or acquiring troubled properties; make property workouts difficult to achieve; and discourage renovations and upgrades to rental properties.

Under the current passive loss rules, losses from rental real estate (e.g., operating expenses, interest or depreciation) are automatically deemed to be passive -- irrespective of the level of the owner's involvement in the rental real estate business. At the same time, income from real estate activities, such as development, construction, management, leasing and brokerage of real property, as well as salary and other income, is treated as active income.

Since passive losses cannot be deducted against nonpassive income, people in the real estate business are taxed on the *gross* income of their overall real estate business operations, not on their *net* income. This is very different from the treatment of all other businesses in America where losses are considered to be passive only if the taxpayer does not "materially participate" in the activity that produces them.

H.R.749 would correct this so that once an individual taxpayer meets a threshold test establishing he or she is in the real property business, the taxpayer would be allowed to prove material participation in his or her rental activity under the same test all other taxpayers now use to prove material participation in their businesses. An individual would be treated as in the real property business if he or she spends 50 percent of his or her annual personal service trade or business time in real property trades or businesses (personal services performed solely as an employee would not count as performed in real property trades or businesses).

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* H.R. 749, introduced in the U.S. House of Representatives on February 3, 1993, is sponsored by the following members of the Ways and Means Committee: Andrews, Matsui, Thomas, Shaw, Archer, Brewster, Bunning, Camp, Cardin, Grandy, Hancock, Herger, Hoagland, Houghton, Jacobs, Jefferson, Johnson, Kopetski, Lewis, McCrery, McNulty, Neal, Payne, Pickle, Santorum, Sundquist. Companion legislation, S.342, was introduced in the U.S. Senate on February 4, 1993.

Losses incurred by an individual qualifying under this test from a rental real estate activity in which he or she materially participates could then be deducted against any income -- the same treatment accorded taxpayers who materially participate in other businesses. In addition, closely held C corporations would receive the same treatment if more than 50 percent of the gross receipts of the corporation are derived from real property trades or businesses.

Pension Investment in Real Estate

H.R.749 would modify the tax rules that apply to ownership of real estate by pension funds. These modifications have been designed to provide liquidity to pension investments in real estate, to permit pension funds to invest in real estate on terms comparable to other investors, and to help end the credit crunch -- all without undermining existing ERISA-based prudent investment rules and limitations.

Pension funds, with their long-term liabilities, are a logical source of capital for long-term real estate investment. However, current restrictions on REITs and certain aspects of the unrelated business income tax rules unnecessarily constrain pension fund investment in real estate.

First, no more than 50 percent of a REIT may be owned by five or fewer individuals. Domestic pension funds are considered one individual, while foreign pension funds are treated as if each pension fund beneficiary is an investor. Due to the small size of most REITs, it is very difficult for domestic pension funds to make economically feasible investments without violating this rule. H.R.749 would correct this so that each fund beneficiary would be considered holding REIT stock. To safeguard against abuse, a pension fund owning more than 10 percent of a REIT would have a portion of the REIT dividends taxed if: (1) the fund is one of a group of funds individually owning more than 10 percent of the REIT and collectively owning more than 50 percent of the REIT; or (2) the fund individually owns more than 25 percent of the REIT.

Second, H.R.749 would modernize the UBIT rules which pension funds must follow to ensure that income from debt-financed real estate is tax-exempt. Current UBIT rules deny tax-exempt status to pension investments in debt-financed real estate if the investment involves a contingent purchase price; sale-leaseback; participating mortgage; or seller financing. H.R.749 would amend the current law to: (1) allow up to 25 percent of the leaseable floor space to be leased back to the seller by the pension fund; (2) allow pension funds to participate in transactions involving commercially reasonable seller financing; and (3) relax the fixed purchase price and participating loan restrictions for sales by financial institutions of real estate they own to pension fund purchasers.

Debt Restructuring

H.R.749 would reinstate the pre-1986 rule that allowed taxpayers to reduce depreciable basis by the amount of any debt forgiven in a qualified real estate loan restructuring agreement. This election to reduce depreciable basis would be in lieu of current taxation of the reduced mortgage debt. This provision is needed because

current tax law tends to discourage loan restructuring agreements and encourage unnecessary property deed-backs and bankruptcy filings.*

Today, individuals who restructure loans on real property are taxed on the amount of debt reduced under the restructuring agreement -- even though no cash is received in the transaction. Frequently the tax would be lower if the property were deeded back to the lender or placed in bankruptcy. The following example helps put this problem into perspective.

> Assume that in 1988 a partnership (GP) purchased depreciable property for $1.2 million. The purchase price was paid with $200,000 cash and a $1 million nonrecourse loan to the lender. In 1993, because of market conditions, the property has a fair market value of $600,000 and an adjusted depreciable basis of $800,000. No principal payments have been made. GP has two 50 percent partners, Ralph, who is insolvent, and Oscar, who is solvent.
>
> Oscar, an experienced real estate manager, offers to infuse $50,0000 cash to GP to be used for marketing and tenant improvements provided that lender will reduce the mortgage debt on the property to its fair market value, $600,000. The lender, making a business determination that it prefers the property remain in the borrower's hands, agrees to the loan restructuring transaction.
>
> Unfortunately, when advised of the current tax law, Oscar is unlikely to agree to this transaction. If Oscar agrees to work with the lender as proposed, he will contribute $50,000 cash and be taxed on $200,000 (a 50 percent share of the $400,000 debt reduction) of phantom discharge of indebtedness income. Assuming a tax rate of 40 percent, the transaction will cost Oscar $130,000 ($50,000 cash infusion plus $80,000 -- 40 percent tax on $200,000 of phantom income). On the other hand, Oscar would recognize only $100,000 (50 percent of the difference between debt and fair market value) of gain and pay only $40,000 in taxes if he rejected the offer and the property was conveyed to the lender in a taxable transaction. Thus, Oscar's agreement to a transaction that reflects marketplace realities will cost him an additional $40,0000 in taxes. The cost difference will far exceed his 50 percent share of the expected equity in the property.

H.R.749 would remove this perverse incentive against market-driven debt restructuring transactions by allowing individuals (including partnerships and Subchapter S Corporations) to exclude from current taxable income any reduction of real property business debt. In return, the taxpayer would reduce the tax basis of owned depreciable property (property subject to restructuring first, then other properties) by the amount of discharged debt. By requiring the taxpayer to lower the depreciable basis in real property by the amount of discharged debt, the taxpayer

* The rule being proposed for restructuring real estate debt is now the law that applies to restructured farm debt. This rule was maintained in 1986 for farm debt in recognition of the credit and values crisis then affecting the farm and agricultural sectors of the economy.

would not avoid taxation. The tax would be paid over time through lower depreciation deductions and, ultimately, would be paid in full when a sale occurs.

National Realty Committee strongly supports the provisions contained in H.R.749 and we urge that they be included in the tax and economic stability package about to be fashioned by Congress.

The Cost Recovery of Leasehold Improvements

Cost recovery is fundamental to our income tax system. True net income is determined by recovering the costs expended on an investment over the same period of time that the investment earns income. Unfortunately, during the last 15 years the cost recovery rules pertaining to leasehold improvements have evolved significantly away from this fundamental "matching" tax precept.

Instead of matching the expenses incurred by a building owner to reconfigure rentable floor space to suit the specific needs of a new tenant with the revenue derived from the lease to that tenant, today's rules dictate that such costs be recovered over the 31.5 year useful life of the building generally. This is a particularly harsh rule since leasehold improvements (e.g., internal walls, wiring, plumbing, etc.) in fact do not have the same useful life as an overall building (which includes foundations, bricks, steel girders, etc.).

Because of this rule, the after-tax cost of building-out space to accommodate a new tenant is artificially high, and construction employment opportunities are reduced. These rules should be reexamined and reformed -- particularly in light of proposals to increase the recovery period for buildings -- so that the costs of constructing leasehold improvements more closely approximate the useful life of the asset constructed, generally the life of the lease-term.

The rules, as they now exist, were not always the case. Before the Economic Recovery Tax Act of 1981 ("1981 Act"), a building owner was entitled to recover the costs associated with constructing improvements to suit the needs of individual tenants over the lease term to which such improvements related. This reflected the fact that "leasehold improvements" constructed for one tenant are rarely suitable for another, and that when the tenant leaves, the space is typically built-out all over again for a new tenant.

This economically sound notion of matching income from the lease with the costs of leasehold improvements was set aside with the 1981 Act. In an effort to simplify the depreciation laws and to provide an incentive to invest in real estate, a single depreciation life of 15 years was established for all buildings, and all improvements made to them. At the time this change for leasehold improvements was considered arbitrary, but not unreasonable, given that the overall useful life of the building shell was in fact much longer than the 15-year recovery period. In addition, if a tenant constructed the improvement then the tenant was permitted to recover its costs over either a 15-year useful life or the remaining term of the lease, whichever was shorter.

However, since the 1981 Act, the recovery period for nonresidential real property has been lengthened to 18 years, to 19 years and finally, under the Tax Reform Act of 1986 ("1986 Act"), to 31.5 years -- without any distinction between buildings themselves and the periodic internal improvements made to accommodate

tenant specifications. Thus, in the relatively short time from 1981 to 1986 the tax treatment for leasehold improvements dramatically changed from a flexible depreciation system that sought to "match" income with expense, to a system that dictates a recovery of expenses over a time period (31.5 years) that in no way relates to the useful life of the asset. Moreover, under the 1986 Act, improvements made by tenants are required to be recovered over the useful life of real estate generally, without regard to the term of their lease.

We strongly urge the Committee to undertake a review of these rules and to rationalize the tax treatment of leasehold improvements by either returning to pre-1981 law, which allowed leasehold expenses to be recovered over the length of the lease, or by establishing a new, separate depreciable class life for leasehold improvements.

Mr. Chairman, and members of the Committee, National Realty Committee is very supportive of the actions taken by this Committee and Congress last year in seeking to address some of the fundamental tax policy concerns of real estate owners, lenders and investors. We are greatly heartened by the proposals put forward by the Administration -- as they too recognize the need to reassess real estate tax policy in the context of facilitating positive overall economic growth -- and we look forward to working with this Committee to fashion a comprehensive package that includes sound real estate-related provisions.

Thank you.

Mr. MATSUI. I would like to now introduce a friend and constituent of mine from Sacramento, CA, Michael Hackard. Mike.

STATEMENT OF MICHAEL A. HACKARD, MEMBER, BOARD OF DIRECTORS, NATIONAL REALTY COMMITTEE AND PRINCIPAL, HACKARD & TAYLOR, SACRAMENTO, CA

Mr. HACKARD. Thank you, Mr. Chairman, members of the committee.

Good afternoon. My name, as the chairman said, is Michael Hackard, and I am a senior partner in the law firm of Hackard & Taylor based in Sacramento, CA. I am also a member of the board of directors of the National Realty Committee.

I am pleased to appear before you again as you begin to formally consider President Clinton's proposal to provide economic stimulus in public investment and deficit reduction. I am from California, a State significantly affected by the decisions made by this committee and a State that significantly affects the overall health and growth of the Nation's economy.

I know firsthand the serious condition of our State's economy, and I can tell you that today the economic news from California is not good. Commercial and industrial property values have fallen from 20 to 50 percent. Jobs and job opportunities are declining. The State has a budget deficit measured in the billions.

We may not be healthy, Mr. Chairman, but we are hopeful. We are hopeful because we have a President who in his first days of office recognized that real estate is an important part of this Nation's economic infrastructure. We are hopeful because President Clinton has encouraged lenders to be lenders and has crafted a thoughtful tax proposal. And we are hopeful today because of the constructive work undertaken by this committee last year and into this year to address America's dysfunctional commercial real estate market.

As you move forward, I encourage you not to forget last year's work on real estate tax issues. In fact, it should be used to supplement the positive proposals put forth by the Clinton administration. It is hoped that these proposals will help stabilize property values which in California and elsewhere have fallen precipitously. Given this environment, lenders and borrowers alike are searching for ways to viably restructure and refinance billions of dollars of loans.

Here is one of the problems with all of this: Since 1986, people who restructure real property mortgages have been immediately taxed on any debt reduced under the restructuring agreement. In other words, restructured debt is considered income that is taxed currently even though no cash is received. In reality, many times the tax associated with these transactions would be lower if the owners simply deeded the property back to the lender.

In last year's vetoed tax bill, Congress included a provision to correct this policy. And, although it is not currently a part of the administration's package, I strongly urge this committee to act on this provision this year.

In conclusion, last year this committee in Congress did the right thing by approving positive changes to the taxation of real estate. I urge you to do the right thing again. In particular, enact a pro-

posal to revise the taxation of real estate debt discharges. I can think of few tax policy changes that could have as dramatic and positive an impact on owners and lenders alike.

Also, as our President, Steven Wechsler, emphasized in his remarks, the tax treatment of the leasehold improvements must be rationalized as well. Such a change is necessary if the depreciation rules are to accurately reflect the economic life of these internal improvements.

Thank you very much, Mr. Chairman.

Mr. MATSUI. Thank you, Mr. Hackard.

Mr. Glunt.

STATEMENT OF ROGER GLUNT, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, AND PRESIDENT, GLUNT BUILDING CO., INC., TURTLE CREEK, PA

Mr. GLUNT. Thank you, Mr. Chairman.

My name is Roger Glunt. I am a homebuilder from Turtle Creek, PA, and I am the current president of the National Association of Home Builders.

On behalf of the National Association of Home Builders and our 160,000 members, I congratulate you for holding this hearing and appreciate the opportunity to appear here today. My testimony will address the portion of President Clinton's proposals which would most directly impact the home building industry.

At the outset, I would like to point out that, during the 102d Congress, NAHB was among the first industry groups to call for the enactment of economic stimulus legislation to spur a housing-led economic recovery. On the Sunday following President Clinton's State of the Union Address, our board passed a resolution supporting the President's economic program.

The temporary Internal Revenue Code provisions pertaining to mortgage subsidy bonds and mortgage credit certificates expired on June 30, 1992. On each occasion in which these provisions were about to sunset, there was extensive congressional debate as to the value of the programs and ownership incentives, and on each such occasion this committee and your colleagues on the Senate Committee on Finance concluded that the programs implemented important policy.

The MRB program supports about 130,000 home purchases each year, including 32,000 newly built homes. In 1992 alone, more than 72,000 homes were purchased through MRB financing. These homes, the average cost of which was $64,270, were purchased by buyers whose average income was $28,525.

Failure to permanently extend MRB's would reduce single family start ups to 20,500 in 1993 and up to 35,000 units per year after 1993. Job losses would be up to 37,000 in 1993 and almost 63,000 after 1993. NAHB urges you to make the mortgage subsidy bond and mortgage credit certificate programs permanent.

We would certainly like to congratulate Chairman Rostenkowski and Representative Charles Rangel for their tireless efforts to permanently extend the low-income housing tax credit. NAHB urges the enactment of Messrs. Rostenkowski's and Rangel's bill, H.R. 18, which would do so.

Our analysis indicates that the low-income housing tax credit supports the construction or rehabilitation of about 130,000 low-income rental units each year including 60,000 to 70,000 new units. The low-income housing tax credit is responsible for more than one-third of all 1992 multifamily starts. Assuming the permanent extension of the low-income housing tax credit, tax-credit-assisted units will probably account for about 18 percent of all multifamily completions and one-quarter of multifamily rental completions over the remainder of the decade.

If the low-income housing tax credit is not extended, we would estimate a loss of 60,000 multifamily starts each year after 1992. The reduction would cost 50,000 jobs and $1.29 billion in wages in the new construction sector.

Without the low-income housing tax credit, it will not be possible to establish rent levels low enough on most new and rehabilitated units to make them affordable to low-income housing tax credit. Mr. Chairman, I am here representing NAHB, but I have spent the last 8 years as a board member of the Pennsylvania Housing Finance Agency so I have firsthand experience in this area.

The limitation on the deductibility of passive activity losses enacted in 1986 have sharply reduced real estate values. The decline in real estate resale values has been a major factor in the number of defaulted mortgages on income-producing properties. Those declines in values have been major contributors to the thrift and bank failures.

The administration's proposal is more restrictive than the provision passed last year as a part of H.R. 11 which would have allowed an offset against all active income regardless of source. We believe that the proposed revision is too limited to be of any real benefit and that the H.R. 11 language would be most effective in restoring lost real estate values.

Another provision of the code that expired on June 30, 1992, is that which allowed self-employed individuals to deduct a proportion of their health insurance costs. NAHB urges that this provision be made permanent.

NAHB, through our nonprofit educational arm, the Home Builders Institute, is actively involved with the targeted jobs tax credit. The administration proposes to permanently extend the program and to expand it to include youth apprentices. NAHB urges that this legislation be enacted.

The administration proposes to provide a 50-percent capital gains exclusion for investors in certain small business stock. NAHB supports reinstatement of a capital gains rate differential for real estate.

The administration proposes to relax the restrictions on debt-financed real estate invested by pension funds. This much-needed change was included in H.R. 11 as passed by the 102d Congress. NAHB urges Congress to include legislation which relaxes the five or fewer rule as a part of the economic plan package.

The administration proposes to designate 50 Federal enterprise zones. We at NAHB believe any such proposal should include a housing component to be viable.

In conclusion, Mr. Chairman, the National Association of Home Builders is acutely aware of the need to reduce the deficit. Indeed,

we support all responsible attempts to do so and, therefore, support the President's economic plan.

However, our industry is not in a position to continue paying a disproportionate share of that effort. A serious lack of economic growth exists in almost all sectors of the economy, not just housing. However, the housing market has been the engine that traditionally pulls the Nation out of recession.

Thank you very much.

Mr. MATSUI. Thank you, Mr. Glunt.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

March 23, 1993

Mr. Chairman, members of the Committee:

My name is Roger Glunt. I am a home builder from Turtle Creek, Pennsylvania and am President of the National Association of Home Builders. On behalf of the National Association of Home Builders (NAHB) and its 160,000 members, I congratulate you for holding this hearing and appreciate the opportunity to appear here today. My testimony will address the portion of President Clinton's proposals, which would most directly impact the home building industry. Specifically, I will address the proposals with respect to the Low-income Housing Tax credit, Mortgage Revenue Bonds (MRBs), passive loss relief for real estate activities (PAL), the facilitation of real estate investments by pension funds, Capital Gains, the Targeted Jobs Tax Credit, the Deduction for Health Insurance Costs of the Self-employed and Enterprise Zones.

At the outset, I would like to point out that during the 102nd Congress, NAHB was among the first industry groups to call for the enactment of economic stimulus legislation to spur a housing led economic recovery. On the Sunday following President Clinton's State of the Union address our Board passed a resolution supporting the President's economic program. As an important part of that policy, NAHB urged Congress to pass legislation which would revise the passive activity loss rules, facilitate real estate investment by pension funds, and permanently extend the provisions with respect to the Low Income Housing Tax Credit, Mortgage Revenue Bonds, the Targeted Jobs Tax Credit, and the Deduction of Health Insurance Premiums for self employed individuals.

At the outset, we would also like to thank Representative Nancy Johnson for introduction of H.R. 776, which would provide a $2,500 credit for homes purchased in 1993. This provision would create about 1,536,000 jobs with a corresponding tax impact of $8,532,000 in federal tax revenue. If it is the will of the Committee to expand the provisions of the Clinton plan, NAHB would welcome its inclusion in any legislation passed by this Committee.

In the past few years, while the country experienced a recession, the housing industry suffered through a de facto depression. The destabilization of real estate and a "credit crunch" transformed the housing segment from a source of economic growth to a source of economic stagnation.

The housing industry has traditionally led the U.S. economy out of recessions. It has done so seven times since World War II. Last year, however, while single family home building experienced some improvements, the housing recovery was modest by historical standards, and the lack of vigor in the housing recovery was a factor in the very limited recovery in the overall economy. Housing continues to lag behind past recoveries and real estate values continue to suffer. We believe that federal tax policy must contain initiatives that will remedy the weakness in the housing industry. We further believe there will be no sustained economic recovery without a recovery in the housing industry.

Single-Family And Homeownership Statistics

Homeownership rates among young families have fallen. The decline in homeownership began in 1980 and continued through 1989 before reversing itself slightly in 1990. The 1990 homeownership rate of 64.1 percent remains well below the 65.6 percent of 1980. The most dramatic drop in the homeownership rate during that period has been among young families who typically are first-time buyers.

The Harvard Joint Center for Housing Studies 1992 report, "State of the Nation's Housing," found that high costs continue to limit access to homeownership for many potential first-time buyers. Only those age 65 and over have shown any increase in homeownership rates since 1980. Much of that shift is attributable to changes in the distribution of income. The share of income flowing to young families has fallen despite the greater number of young families with two earners in the labor force.

The demand for single-family homes should be strong during the 1990s. Single-family starts should not be affected by the expected slowdown in household growth relative to past decades because changes in the age structure of the population will favor higher rates of homeownership, and greater demand for single-family homes.

Multifamily Rental Demand

Demand Growth

The multifamily picture is less encouraging.

An additional 350,000 multifamily units will be needed each year through the 1990s to accommodate an increased number of households and to replace existing units removed from the housing stock. Approximately 300,000 multifamily units will probably be needed in buildings with 5 or more units with the balance in 2 to 4 unit buildings. Most of the growth in the demand for multifamily rentals will be among moderate-, low and very-low income households.

The demand for additional multifamily rental housing is the sum[1] of the projected growth in multifamily renter households, the projected demand for units to replace the number that are lost on net from the available stock, and changes in the number of vacant units needed to accommodate household growth.

Meeting the Demand

The Joint Center for Housing Studies of Harvard University study of the State of the Nation's Housing in 1991 concluded that "today's level of multifamily starts is well below that required to accommodate even modest projected increases in renter households--let alone allow for replacement of units demolished or otherwise removed from the inventory." Demand for multifamily housing is about 350,000 units per year and the level of multifamily starts in 1991 is only half that number[2].

Although there is currently an excess supply of vacant units in certain regions, net additions to the rental stock from changes in the existing stock and new construction will almost certainly not be sufficient to meet the future demand for multifamily housing unless steps are taken soon to encourage new construction. An undersupply of multifamily rentals will cause rental markets to tighten, rents to rise, and housing cost burdens on the poor to increase. A lack of affordable rental housing could lower the rate of household formations. Some who might otherwise form renter households may be forced to double up with other families, remain in their parents' homes, and, in the worst case, end up homeless.

Since the Tax Reform Act of 1986, multifamily production has plummeted and except for units built under the LIHTC, what little production that has been taking place has been targeted towards middle- and upper-income renters. In 1985, 56 percent of all multifamily completions rented for less than $450, but by 1989 only 19 percent were so rented. This has contributed to an annual average net loss of 324,000 multifamily rentals with rents under $450 between 1985 and 1989[3]. The loss of these units has meant greater hardships for low-income renters and has reduced the flow of existing moderate-income units into the low-income stock.

Virtually all of the limited volume of multifamily rental construction since 1986 that has been intended for low and moderate income families has been supported by the low income tax credit program -- the only remaining tax incentive for production of affordable rental housing.

The National Association of Home Builders urges you to pass the Clinton plan. Specifically, NAHB urges you to permanently extend, and make certain technical corrections to, the low-income housing tax credit program, permanently extend the mortgage revenue bond program for first-time homebuyers, the targeted jobs tax credit and the deduction for health insurance premiums of the self-employed, revise the passive loss rules with respect to real estate, relax the limitations on pension fund investment in real estate, and to re-instate a capital gains rate differential for real estate.

Mortgage Revenue Bonds

The temporary Internal Revenue Code provisions pertaining to mortgage subsidy bonds and mortgage credit certificates (hereinafter MRBs) expired on June 30, 1992. On each occasion in which these provisions were about to "sunset", there was extensive Congressional debate as to the value of the programs as homeownership incentives. And on each such occasion, this committee, and your colleagues on the Senate Committee on Finance, concluded that the programs implemented important policy.

By way of background, more than one and a half million taxpayers have become first-time homeowners as a result of the MRB program. The MRB program supports about 130,000 home purchases each year including 32,000 newly built homes. In 1992 alone, more than 72,000 homes were purchased through MRB financing. These homes, the average cost of which was $64,270, were purchased by buyers whose average income was $28,525[4].

In 1991 (the latest national data available), the average price of a conventionally financed home was $114,400, and the purchaser averaged $52,100 in annual income[5]. Clearly, the MRB program has assisted <u>moderate</u> income taxpayers attain the dream of homeownership.

The importance of these facts cannot be understated. According to studies conducted by the Joint Center for Housing studies, homeownership levels have been declining over the past decade. Surprisingly, this decline, which was most pronounced among young taxpayers, came at a time of economic strength. Moderate income young taxpayers, for whom the dream of homeownership should be becoming a reality, are the very persons finding themselves unable to purchase a first home.

The MRB program has been one of the most effective programs in addressing the affordable homeownership problem. More importantly, the MRB program addresses the problem at minimal expense. The "private activity" tax-exempt bond cap enacted in the Tax Reform act of 1986 (TRA of 1986) limits the volume of bonds issued and the loss of revenue to the Treasury. According to Joint Committee on Taxation estimates, permanent extension of the MRB program would cost only $924 million over a five-year period, a relatively small amount when considered in connection with the social and economic benefits of the programs.

Failure to permanently extend MRBs would reduce single family starts 16,000 to 20,500 in 1993 and 30,000 to 35,000 per year after 1993. Job losses would be 29,000 to 37,000 in 1993 and 54,000 to 63,000 per year after 1993[6].

One substantive point which we must address, however pertains to the recapture provision enacted in 1990. The provision not only limits the ability of moderate income taxpayers, to whom the program is targeted, to capitalize on the equity in their homes, it discourages participation in the program. By way of example, one builder has informed us that he has been unable to sell much needed affordable homes, which he built in reliance on the prospective purchasers being able to utilize MRBs, because of buyer fear of the recapture provisions. Without the use of their accumulated equity, many homeowners cannot continue on the ladder of homeownership. Moreover, the impact of carrying such homes in inventory can be devastating to the builder and causes administrative difficulties for the state housing agencies.

The National Association of Home Builders, (NAHB) urges you to make the mortgage revenue bond and mortgage credit certificate programs permanent, as proposed by the Administration and H.R. 462 introduced by your colleague, Mrs. Kennelly. We also encourage your re-examination of the recapture provision, which we believe is so onerous as to defeat the purpose of the program.

Low-Income Housing Tax Credit

On behalf of the NAHB, I would like to congratulate Chairman Rostenkowski and Representative Charles Rangel for their leadership with respect to the temporary extension of the low income housing tax credit in past years and for their tireless efforts to permanently extend the program, as evidenced by their early introduction of H.R. 18 during this Congress. Chairman Rostenkowski and Representative Rangel, along with their Senate colleagues George Mitchell, John Danforth, and David Boren can take a great deal of pride in their records on this matter. Like the Mortgage Revenue Bond program, the LIHTC expired on June 30, 1992. NAHB urges the enactment of Messrs. Rostenkowski and Rangel's bill, H.R. 18, which would extend the program permanently, as proposed by the Administration.

The LIHTC has established a record of unparalleled success. In 1989 alone, over 125,000 low-income housing units received tax credit allocations[7].

For the multi-family construction industry, this program has been our life preserver in a dismal economic time. Our analysis indicates the LIHTC supports the construction or rehabilitation of about 130,000 low income rental units each year including 60,000 to 70,000 new units.

The LIHTC is responsible for more than one-third of all 1992 multifamily starts, nearly half of all rental multifamily starts, and virtually all the new rental units available to households with incomes under $15,000[8]. Failure to revitalize the program would bring the multifamily sector to depression levels.

Failure to keep the credit would also eliminate the LIHTC-sponsored rehabilitation of about 50,000 to 55,000 units per year in 1993 and 60,000 in years beyond[9]. A permanent solution is necessary to correct the disruptions that have heretofore kept the credit from being a consistent factor in planning low-income multifamily rental projects.

Assuming the permanent extension of the LIHTC, tax credit assisted units will probably account for about eighteen percent of all multifamily completions and one quarter of multifamily **rental** completions over the remainder of the decade. More importantly, tax credit assisted units would account for as much as 93 percent of all low-income multifamily rentals completed in the 1990s.

If the LIHTC is not extended, we estimate a loss of 60,000 multifamily starts each year after 1992[10]. The reduction would cost 50,000 jobs and $1.29 billion in wages in the new construction sector[11]. Another 16,500 jobs and $430 million in wages in the remodeling industry would be lost in each future year.

Without the LIHTC, it will not be possible to establish rent levels low enough, on most new and rehabilitated units, to make them affordable to low-income tenants. Therefore, the loss of the LIHTC will stop many low-income rental units from being built or rehabilitated.

Foregone taxes from a single year's LIHTC are $313 million per year. Since the credit is taken for 10 years, the ultimate cost is $3.13 billion.

During the debate on the extension of the LIHTC, we urge that further substantive examination of the program be undertaken. While much has been done to perfect the application of the LIHTC over the past several years, there are still alterations needed.

Like all multifamily projects, tax credit assisted projects depend on the availability of debt financing. Due to the credit crunch, permanent debt financing for all forms of multifamily housing production, including that for tax credit projects, has been in very short supply. Conventional lenders are often most reluctant to lend to multifamily projects that involve tax credits because these projects typically involve complex multi-party financing arrangements. Congress is in a unique position to help solve this problem. By allowing for the full nine percent tax credit to be made available to projects financed with tax-exempt bonds and other below market federal loans, and by restoring the requirement that a minimum of 20 percent of the units in a multifamily rental project be occupied by families whose income is 80 percent or less of area median gross income adjusted for family size, Congress would enable housing finance agencies and other lenders to get back into the business of providing permanent financing for tax credit projects.

While there may be some concern that such a change would result in too rich a subsidy, we would argue to the contrary. The state credit agencies are already charged with the responsibility of allocating the credit in amounts limited to those which make the project feasible. This would merely provide them with one more tool to use in developing sound projects. Moreover, the cost of such a change would be minimal. Both the LIHTC program and the tax-exempt bond program are already accounted for, hence, their combined use would have little, if any, revenue impact.

NAHB also believes that Congress may eliminate the need for subsidy layering to achieve project feasibility. Removal of tax credit rate limits would eliminate the cumbersome and time-consuming process of layering additional financing and subsidy sources to achieve project feasibility. Many communities with a shortage of affordable housing do not have the resources or access to the additional financing sources that are required to produce LIHTC projects. Since the agencies that administer the tax credit must determine that project costs are reasonable and must set the credit rate at a level which permits project feasibility, the elimination of the limits on the credit rates would contribute to a more efficient LIHTC program.

Further, allowing investors to receive tax credits for units occupied by families in the 60-to-80 percent of median income range would reduce the need for layering. Specifically, the program should be amended to allow credits for occupancy of up to 30 percent of rental units in a multifamily tax credit project by households whose income is in the 50, or 60, to 80 percent of area median gross income ranges, while maintaining the program's current minimum low-and moderate-income targeting requirements.

Finally, NAHB believes that the amount of credit individual investors can utilize under the passive loss rules should be increased. We understand that there is a possibility that, absent such change, there will not be sufficient investor equity to fund all the projects which will be produced under the program. Moreover, NAHB supports the elimination of the $25,000 loss limitation.

A loss of the MRB and LIHTC programs would reduce federal, state and local tax receipts by over $1 billion each year. Total job loss from failure to keep both programs would likely be almost 100,000 jobs in 1993 and 120,000 in future years. Federal tax revenues would drop by $955 million in 1993 and by $1.18 billion in future years. We urge you to permanently extend these most important provisions to the direct production of affordable housing.

Revise Passive Activity Loss Rules

The limitations on passive activity loss have sharply reduced real estate values. Indeed, subsequent to enactment of the PAL rules, the value levels of many properties were expected to fall by more than 20 percent, [12] well below reproduction cost. The decline in real estate resale values has been a major factor in the number of defaulted mortgages on income-producing properties. Those declines in values have been major contributors to thrift and bank failures. Revision of the PAL limitations as to real estate would partially restore value to real estate.

The Administration's proposal would allow deduction of the lesser of (a) the net loss for the taxable year from rental real estate activities in which the taxpayer materially participates or, (b) PAL for the year. The deductible loss would be limited to the lesser of (1) the taxpayer's net income from nonpassive real property trade or business activities or (2) taxable income. This rule is more restrictive than the provision passed last year as a part of H.R. 11, which would have allowed an offset against all active income regardless of source.

We believe that the proposed revision is too limited to be of any real benefit and that the H.R. 11 language would be most effective in restoring lost real estate values. In any event, simply revising the PAL rules, by themselves, would not produce sufficient economic stimulus to spur a recovery. To be effective, PAL revision must be more encompassing than the instant proposal and must be a part of a larger, more comprehensive tax package. NAHB would like to express its appreciation for the diligent and continued efforts of Representatives Andrews, Thomas, Matsui and Shaw with respect to their introduction of H.R. 749, to reform the passive loss rules as to real estate. This legislation is a step in the right direction.

Partial Deductibility of Health Insurance Costs of the Self Employed

Another provision of the code that expired on June 30, 1992 is that which allowed self-employed individuals to deduct a portion of their health insurance costs (Internal Revenue Code section 162(l)). Retention of this provision is a simple case of equity. This provision affords entrepreneurs treatment similar to those citizens whose health insurance is paid for by an employer. The home building industry is comprised largely of small independent businesspersons, whose insurance is therefore, self-provided. NAHB urges that this provision be made permanent, as proposed by the Administration, and increased in amount as proposed in H.R. 162, introduced by Mr. Grandy.

Targeted Jobs Tax Credit

NAHB, through our nonprofit educational arm, the Home Builders Institute (HBI), is actively involved with the Targeted Jobs Tax Credit (Internal Revenue Code Section 51). HBI helps place Job Corps graduates into positions in our industry after training them in the construction trades. The targeted jobs tax credit is an invaluable tool to encourage employers to hire newly trained young people. Not only is this program beneficial in terms of assisting in the provision of affordable housing, but the fact that it affords the opportunity for under-privileged citizens to learn a marketable skill cannot be overstated. The Administration proposes to permanently extend the program and to expand it to include youth apprentices. Additionally, H.R. 325, introduced by Mr. Rangel, would make this program permanent. NAHB urges that this legislation be enacted.

Capital Gains

The Administration proposes to provide a 50 percent capital gains exclusion for investors in certain small business stock. NAHB supports reinstatement of a capital gains rate differential for real estate. More favorable capital gains treatment would not only encourage purchases of existing properties, but would encourage investment in new construction, rehabilitation and remodeling. It would also reduce required rents on new construction. For example, taxation of capital gains at 60% of ordinary income rates would reduce new construction rental amounts by 3.4%.[13]

Facilitate Real Estate Investments by Pension Funds

The Administration proposes to relax the restrictions on debt-financed real estate investments by pension funds, permit title holding companies to receive some unrelated business taxable income (UBTI), and exclude from UBTI, (a) gains and losses from the disposition of certain real property acquired from financial institutions in conservatorship or receivership, as well as, (b) loan commitment fees and premiums from unexercised options on real estate. The proposal does not, however, provide for relaxation of the "five or fewer" rule with respect to investments in Real Estate Investment Trusts by pension funds. This much needed change was included in H.R. 11 as passed by the 102nd Congress. NAHB urges Congress to include legislation which relaxes the "five or fewer rule" as a part of the Economic plan package.

Increase Recovery Period for Depreciation of Nonresidential Real Property

The Administration's proposal would provide that non-residential real property would be depreciated using the straight-line method and a recovery period of 36 years, generating revenue in the amount of $2.482 billion. NAHB agrees with the Administration's proposal but only if the revenue is to be used as an offset for the cost impact of the PAL revision.

Enterprise Zones

The Administration proposes to designate 50 federal enterprise zones which would benefit from targeted employment and investment incentives to stimulate revitalization of these distressed areas. NAHB believes any such proposal should include a housing component to be viable. To facilitate development of affordable rental housing, the enterprise zone proposal may provide for an increase in the amount of credit individuals can utilize under the passive loss rules, as set out above. In this regard, the $25,000 loss limitation should be eliminated with respect to developments located within the enterprise zone.

Further, the proposal should provide first-time home ownership incentives, creating viable communities to support the enterprise zones.

Mortgage Interest Deduction

The mortgage interest deduction is the cornerstone of our housing policy. That policy has helped turn this nation from one of renters to one of homeowners. It is not easy to quantify the value and importance of homeownership. It is woven into the very fabric of our social political stability as a nation. Millions of Americans owning their own homes provides an investment in neighborhoods, and an investment to hedge against inflation. The more than a trillion dollar value in home equity provides a nest egg for older Americans and supports their retirement.

To limit the mortgage interest deduction would send the wrong signal at the wrong time. It would have a dramatic impact on property values and cause extensive disruption in the market place. Financial institutions would be effected and it would serve to lay off workers, much like the affect of the luxury tax. We believe it would be counter-productive to the President's goal of economic recovery. We applaud the President and this Administration for supporting this very important provision - which promotes the dream of homeownership.

CONCLUSION

The National Association of Home Builders is acutely aware of the need to reduce the deficit. Indeed, we support all responsible attempts to do so and, therefore, support the President's economic plan. However, our industry is not in a position to continue paying a disproportionate share of that effort. A serious lack of economic growth exists in almost all sectors of the economy - not just housing. However, the housing market has been the engine that traditionally pulls the nation out of recession.

The National Association of Home Builders continues to advocate the immediate enactment of economic stimulus legislation. In this regard, NAHB policy provides for a five point program to spur a recovery in the housing industry. In the opinion of the NAHB, the proposals set out by the Administration are central elements of said program. NAHB looks forward to further working with you and your staff to propose and implement solutions to sustain the Nation's economic recovery.

END NOTES

1. Total housing production in the 1990s will average 1.5 million housing units. The source of demand will be comprised of 1.16 million additional households per year, .13 million more units to maintain vacancies, and .21 million replacement units for removals.

2. *The Future of Home Building - 1992 to 1994 and Beyond,* National Association of Home Builders, 1992, p. 9.

3. *The Future of Home Building - 1992 to 1994 and Beyond,* National Association of Home Builders, 1992, p. 184.

4. National Council of State Housing Finance Agencies 1992 Snapshot Survey.

5. American Housing Survey, 1991.

6. *A Plan to Stimulate the Nation's Economy*, National Association of Home Builders, February 1992. The MRB program supports the purchase of about 130,000 homes in an average year, of which 32,000 are new homes. A drop of 1,000 housing starts translates into a loss of 1,700 jobs.

7. National Council of State Housing Finance Agencies.

8. Approximately 65,000 LIHTC units were started in 1992, compared to 170,000 units in buildings with 2 or more units of which 129,000 were offered for rent. Incomes below $15,000 are capable of paying $375 per month in gross rent (including utilities) which is below the return necessary for an average market rate unit.

9. National Council of State Housing Finance Agencies.

10. *A Plan to Stimulate the Nation's Economy*, National Association of Home Builders, February 1992.

11. NAHB estimates, updating 1981 Bureau of Labor Statistics data, show that 826 jobs are created for every 1,000 additional multifamily units and $21.5 million added wages are earned per 1,000 starts.

12. *Real Estate Outlook*, National Association of Realtors, July 1991, p.13.

13. *Real Estate Outlook*, National Association of Realtors, July 1991, p.15.

Mr. MATSUI. Mr. Elrod.

STATEMENT OF ROBERT ELROD, PRESIDENT-ELECT, NATIONAL ASSOCIATION OF REALTORS, AND PRESIDENT, ATKINS, ELROD & CO., ORLANDO, FL

Mr. ELROD. Mr. Chairman, my name is Bob Elrod. I am the 1994 president of National Association of Realtors and president of Atkins, Elrod & Co., a commercial real estate firm in Orlando, FL. I am here today on behalf of the 750,000 members of the National Association of Realtors, and we wish to thank you for holding these hearings and for receiving our testimony on the administration's budget and plan for economic growth.

We salute the Clinton administration for recognizing the valuable contribution that real estate makes to the economy and for recognizing the industry's capacity to lead the Nation out of a recession and into economic recovery and growth.

Moreover, we commend the administration for taking this important first step toward enactment of a balanced real estate package. It contains provisions that apply to both the residential and commercial sectors and to both owner-users and to investors. The Clinton plan corrects some imbalances that exist in the present system but does not undermine justifiable reforms that were enacted in the 1980's. Thus, the package, when enacted, will not create opportunities for abusive tax shelters and does not carry the potential for reigniting the go-go market that led to overbuilding and see-through buildings.

We must comment, as well, on the good judgment shown by the administration in retaining current law as it relates to itemized deductions. In particular, we salute Chairman Rostenkowski for his continued public commitment to holding the line on the $1 million cap that was enacted in 1987. Today's low interest rates are extremely helpful to the rally currently being experienced in the housing market, and we urge the committee to resist any temptation to stifle that recovery by modifying the rules applicable to itemized deductions.

The real estate tax package the President proposes builds on the foundation of important work done by this committee in 1992. Chairman Rostenkowski skillfully guided two bills to the House last year, and these packages bore his imprint. It contained the fruits of the hard work done by Messrs. Andrews and Thomas in gaining the consensus of their colleagues in crafting a solution to the difficult problems that face this industry.

We support all five components of the Clinton package: Extension of expiring provisions, changes to the passive loss rules, improvement to the pension investment rules, and changes to depreciable lives for nonresidential real estate.

We do, however, believe that improvements can be made in the fine print of several of these provisions.

The model we would propose for changing the fine print is found in H.R. 749, a bill introduced by Messrs. Andrews and Thomas and cosponsored by two-thirds of this committee. H.R. 749 contains provisions identical to H.R. 11, the bill President Bush vetoed last November. In particular, we draw the committee's attention to three

features of that bill that should be incorporated in the Clinton package, and these are as follows:

In passive loss, we salute the Treasury Department for acknowledging the inherent unfairness of current law. The administration's proposal, if enacted without modification, would improve current law but would still not mitigate all of its unfairness. The administration proposes that losses from rental activities in which the professional materially participates be used to offset other real estate income. H.R. 749 allows the losses as offsets against all the income, and we believe that the result in H.R. 749 is the correct one.

In pension investment, the National Association of Realtors has been a primary figure in devising a strategy for creating a secondary market for commercial mortgages. The pension investment provisions in the Clinton plan are critical to the success of that effort. The Clinton plan, however, omits one crucial feature that passed Congress twice in 1992. This feature is the provision that would enhance the utility of the Real Estate Investment Trust as a vehicle for enhanced liquidity in commercial finance. The provision we seek is contained in H.R. 749, and we urge the committee to adopt it.

In debt restructuring, we urge the committee to incorporate into the plan the debt restructuring provisions of H.R. 749. This would enhance the ability of owners to hold on to their properties. We support the comments made earlier by the panelists.

While we understand that changes to depreciation are the requisite means to pay for improvements we seek to current law, we must note that our support for this concept has drawn some criticism from our commercial members. They point out, quite correctly, that making depreciable lives even longer than current law does cause a gross distortion to the recovery of the costs for improvements made for tenants.

We can all agree that the life of the building shell can easily be the 31.5 years in current law or 36 years in the Clinton proposal or even the 40 years in H.R. 11. But it is absurd to believe that the interior elements of that structure will last for even 31.5 years, much less 36 or 40 years. It is similarly absurd to think that the cost of improvements made for a tenant will last 40 years.

We, therefore, urge the committee to examine the cost recovery system that applies to tenant or leasehold improvements so that a system can be devised that more nearly reflects true economic recovery for these costs and that more nearly conforms with the traditional accounting concepts of matching income and expenses.

We support the real estate package in the Clinton tax proposal and believe that the total package is complementary to our objective of helping the real estate industry lead the Nation to economic recovery. We eagerly await the presentation of the fleshed-out proposals expected in April.

The Clinton package breaks no new ground. It can be improved with the additions and modifications we suggest, and we urge timely action. And we will be pleased to answer any questions.

Mr. MATSUI. Thank you, Mr. Elrod.

[The prepared statement follows:]

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

MARCH 23, 1993

INTRODUCTION

Mr. Chairman and Members of the Committee. My name is Robert Elrod, the 1994 President-Elect of the National Association of Realtors®. I am also President of Atkins, Elrod & Co., a commercial real estate firm in Orlando, Florida. I appear here today on behalf of the 750,000 members of the National Association of Realtors®. The Association represents virtually every facet of the real estate industry, including REALTOR® brokers and salespersons, developers, appraisers and property managers. We wish to thank you for holding these hearings and for receiving our testimony on the Administration's budget and plan for economic growth.

We salute the Clinton Administration for recognizing the valuable contribution that real estate makes to the economy and for recognizing the industry's capacity to lead the nation out of recession into economic recovery and growth. Moreover, we commend them for taking this important first step toward enactment of a balanced real estate package. It contains provisions that apply to both the residential and commercial sectors, and to both owners and investors. The Clinton plan corrects some imbalances that exist in the present system, but it does not undermine justifiable reforms that were enacted in the 1980's. Thus, the package, when enacted, will not create opportunities for abusive tax shelters, and does not carry the potential for reigniting the go-go market that lead to overbuilding and see-through buildings.

We note, as well, that the real estate tax package in the President's plan builds on the foundation of the important work done in this Committee in 1992. Chairman Rostenkowski skillfully guided two tax bills to the House last year (H.R. 4210 and H.R. 11). Those packages bore the imprint of his leadership, and of the hard work done by Messrs. Andrews and Thomas in sponsoring bills and gaining the consensus of their colleagues in crafting a solution to the difficult problems that face this industry. Both of these bills were subsequently vetoed for reasons unrelated to the real estate package that they contained. We wish to thank this Committee for its efforts.

Our testimony will focus almost exclusively on the real estate portions of the package. Our members will be affected by many of the bill's other provisions. Many are likely to pay more tax because of rate increases, meals and entertainment restrictions, the energy tax and, in some cases, the alternative minimum tax. Nonetheless, as the nation's largest real estate organization, we choose to focus our attention on the proposed real estate changes.

Our message today may sound overly familiar to some long-time members of this Committee. While we have been beating the same drum since 1986, we must nonetheless continue. During the years since 1986, the predictions we made then about decline in the real estate market have unfortunately come true. Some locations around the country have experienced as much as a 30 percent decline in the value of real estate in their markets. Imagine the effect on the tax base of that decline. Local governments are forced to cut back on schools, safety and services. Imagine, too, the effect on the owners of those properties. Many of these owners are average Americans -- retirees, working people, owners of small commercial and residential units who are affected in dramatic ways by the fall in property values. Federal Reserve data shows that fairly significant amounts of non-owner-occupied real estate are held by households in income groups below $50,000. These individuals are adversely affected when real estate values fall. Retirement incomes are reduced, improvements are delayed, and family savings plans are eroded. The decline in property values reaches well beyond the syndicators and the glass see-through towers built in the 80's.

Another way to express this 30 percent decline in real estate values is to compare the loss to the stock market crash of 1987. So far during the 1990's, the value of commercial real estate has declined by an amount comparable to the decline in the value of the stock market in the 1987 crash. If localities were to make up the difference by imposing new taxes on homeowners, the results would be harsh, indeed. Among the hardest hit would be homeowners in Washington.

D. C., who would be required to pay an additional $696 in added property taxes to absorb a 20 percent devaluation of commercial real estate.

Clearly, it is in everyone's best interest to stabilize real estate values in order to avoid property tax increases of this dimension on families. The Clinton plan for real estate would help to achieve that objective. The plan needs a few refinements, which we will describe below, but, generally, it will go a long way toward mitigating the harsh impact that current federal tax policy has on real estate markets.

PASSIVE LOSSES

The Administration's statement of the "Reasons for Change" to the passive loss rules describes accurately and eloquently the best arguments for changing the passive loss rules. The Administration states:

> A taxpayer whose principal business involves real estate (including rental real estate) is disadvantaged under current law. Even if the taxpayer materially participates in all aspects of the business (including rentals), losses arising from the rental of real property may not be used to offset income from other aspects of the taxpayer's real estate business, except to the extent of the $25,000 allowance. . . . Thus, real estate professionals are treated less favorably than other business professionals who are allowed to deduct losses from activities in which they materially participate.

Simply stated, we concur in their judgment, and are pleased that they demonstrate so clearly their understanding of the fundamental flaw of the passive loss rules.

We do wish to comment on one aspect of the "fine print," however. The Clinton proposal would permit real estate professionals who satisfy the material participation test to deduct their rental losses from only their real estate income. If this standard were adopted, then real estate professionals would continue to be treated more harshly than all other business persons. All other business persons who satisfy the material participation test with respect to their activities are permitted to deduct losses from all income, including portfolio income. We believe that it would be appropriate to permit real estate professionals who satisfy the material participation test to receive the same treatment, so that they could deduct their losses from all income.

A majority of this Committee has cosponsored H.R. 749, an Andrews-Thomas bill that contains three important real estate provisions, all identical to provisions that passed the Congress in 1992 as part of H.R. 11. That bill was vetoed for reasons unrelated to the content of the three real estate provisions. The passive loss provision in H.R. 749 would achieve the result that we have described above, and would permit real estate professionals to use their losses against all income. In all other respects, the Clinton passive loss proposal and its counterpart in H.R. 749 are identical. Thus, while we actively support the Clinton proposal, we would urge the Committee to make the correction provided in H.R. 749.

EXPIRED PROVISIONS

On June 30, 1992, a series of provisions, unrelated to one another but considered en bloc, expired because legislation to reauthorize them was vetoed (H.R. 4210), and legislation to renew them was also vetoed as part of H.R. 11. Two important provisions related to real estate. Together and separately, those two provisions are cornerstones to any U.S. policy to promote affordable housing. In 1992, Congress recognized their importance, and in various versions of H.R. 11 and H.R. 4210 voted to extend or to make permanent the low income housing tax credit and the qualified mortgage bond (QMB) provisions, better known as the mortgage revenue bond (MRB) and mortgage credit certificate (MCC) programs.

Now, President Clinton has proposed making these provisions permanent. Similarly, Chairman Rostenkowski and Mr. Rangel have introduced bills to make the low income housing credit permanent, and Mrs. Kennelly has introduced a bill to make the MRB program permanent. Similar bills have been introduced in previous Congresses, and have had the support of huge majorities in each Congress.

We wish to join the chorus of support, and urge the Committee to make these important programs permanent. The provisions are essential if we are to give anything more than lip service to the national goal of affordable housing. Making the programs permanent removes uncertainty from the states that ably administer these programs, and assures that funds and programs will be available for families of low and moderate income that seek decent, reasonably priced homes.

PENSION INVESTMENT IN REAL ESTATE

For many years, members of Congress, including Chairman Rostenkowski and then-Senator Bentsen, have sought ways to attract pension capital to real estate markets, while preserving the rules imposed on fiduciaries to protect the beneficiaries of those plans. The rules that have been in place for many years do, indeed, protect the beneficiaries, but they have created substantial barriers to prudent fund managers who wish to make long-term investments in sound real estate. These barriers were, no doubt, correct models when they were enacted. In today's complex financial markets, however, the barriers are artificial impediments that strangle both fund managers and financial institutions. Change becomes essential. In 1992, the tax writing committees and the Administration settled on a series of rules that remove barriers to investment, while preserving protection for the beneficiaries. These changes reflect more accurately the operation of financial markets today. The Clinton Administration has now made similar proposals, and we support the proposed changes.

As with the passive loss rules, however, the "fine print" reveals that something is missing. In this case, the missing element is the change proposed in 1992 to the rules governing real estate investment trusts (REITs). Both H.R. 4210 and H.R. 11, the two vetoed bills, contained a provision that would have modified the so-called "five or fewer" rule. Under current law, a U.S. pension that invests in a REIT is treated as one person. In practice, it therefore becomes extremely difficult for a U.S. pension to invest in a REIT, because the large block of capital held by that one "person" can cause the REIT to violate the rule that requires that no "five or fewer" persons may hold more than half of the REIT's outstanding stock. Oddly, a foreign pension is treated differently. A foreign pension is not treated as a single person. Rather, each beneficiary of a foreign pension is treated as a separate person. Therefore, a foreign pension can more easily place a large block of capital in a REIT with no fear that the five or fewer rule will have been violated.

H.R. 749, noted above, includes revisions to the REIT rules as part of the pension investment section. We urge the Committee to include this REIT provision, or the similar provision in H.R. 4210 as part its tax proposal.

DEPRECIATION

Throughout the debate on the passive loss rules and other corrections to the taxation of real estate, our industry has recognized the requirements of the budget process, and has worked with this Committee to find ways to "pay for" the revisions we have sought. For good or for ill, the method that was chosen was to revise the rules for depreciation. We have supported the bills that have contained provisions to extend depreciable lives, and we do not withdraw that support today. We must note, however, that we have been reluctant to agree to depreciation changes, and that some of our commercial sector members have challenged our decisions. Nonetheless, we have also realized that much good would come from making the changes we seek, so we willingly, though sometimes regretfully, acknowledge the realities of the budget process. Thus, we accept the changes to depreciation with the understanding that they are the means of paying for the President's proposals to improve real estate taxation.

We must comment, however, that these proposed changes cause a gross distortion to one aspect of commercial development. When a developer or owner secures a new tenant for either a new or existing building, the developer or owner often must configure the space to satisfy the needs of the tenant. Prior to the enactment of ACRS in 1981, the costs of these tenant improvements were amortized over the term of the lease. When ACRS, with its artificial 15-year depreciable life for real estate was adopted, it was a reasonable tradeoff to drop this amortization rule in exchange for the simplification brought about by lumping all costs into a single 15-year life for the entire property.

Now, however, we are light years away from a 15-year life, and the trade-off made in 1981 is no longer valid. We can all agree that the life of a building shell can easily be the 31.5 years of current law, or the 36 years of the Clinton proposal, or even the 40 years in H.R. 11. It is absurd, however, to believe that the interior elements of that structure will last for even 31.5 years, much less 36 or 40 years. It is similarly absurd to think that the costs of improvements made for a tenant will last 40 years. The term of a lease is often less than even 10 years, much less 36 or 40. Yet under current law, the costs of tenant improvements must be written off over 31.5 years. Even at the end of the lease, the remaining unamortized costs will remain outstanding, to be written off over the remaining unexpired depreciable life. This violates all familiar accounting concepts of matching income with expense, and does great violence to common sense and to the rate of return on the improvements. We urge the Committee to review this problem, and to find a solution to the problem of amortizing the costs of tenant or leasehold improvements. The optimal solution, of course, would be to apply traditional accounting concepts and match the costs against the income, by returning to the pre-1981 rule that permitted the costs to be amortized over the term of the lease. If revenue constraints make this impossible, then we would be pleased to work with the Committee to craft a solution that more nearly reflects the reality of economic lives for these improvements.

DEBT RESTRUCTURING

One provision from H.R. 11, and contained in H.R. 749 appears to be missing in action. This is a provision that would grant some relief to property owners who are unable to support their existing properties, and who thus face the loss of those properties. Under current law, their worst option is to hold on to the property. This occurs because of the discharge of indebtedness rules. If the institution holding the mortgage is willing to enter into a so-called "workout" agreement, then the financial institution writes down or forgives a portion of the mortgage or other indebtedness related to the property, and the parties agree to new payment terms. That debt restructuring agreement becomes a taxable event. Thus, even though no cash has been generated, the forgiven debt becomes currently taxable income. If the property owner/taxpayer declared bankruptcy, there would be no taxable event. Similarly, if the property owner/taxpayer simply gave the entire property back to the lending institution, there would be no taxable event.

It seems unreasonable and inadvisable that the tax laws should provide an incentive to abandon property or to declare bankruptcy. Current law recognizes this fact as it pertains to farmers. The discharge of indebtedness rules that apply to farmers permit the farmer to hold on to his/her property and to defer the taxable event by reducing the tax basis of the property that secured the debt and, where applicable, the basis of other depreciable real property. This has the effect of reducing the amount of depreciation allowances each year, and of increasing the amount of any capital gain on any later disposition of the property. Thus, the tax is paid over time, but the impact of the discharge is not borne currently.

We seek to conform the discharge of indebtedness rules so that the rule applicable to farmers is made available to all taxpayers. Interestingly, this was the rule before the 1986 tax reform. When the law was changed in 1986, no particular abuses were cited, and we were not aware of any objections to the provision when it passed Congress in 1992. We do not understand why the Clinton Administration did not include the provision in its package. We urge the Committee to adopt this change. We believe it is in the best interest of both the owners of property and the financial institutions that hold the debt on those properties to provide rules that help the property stay in private hands.

CAPITAL GAINS

The National Association of Realtors® has no position on tax rates, although, like most Americans, our members believe that the government should operate efficiently to keep those rates as low as possible. We have, however, actively supported all efforts to restore a meaningful capital gains differential.

In the past, the capital gains exclusion operated as a sort of rough justice to give taxpayers some incentive to hold property for the long haul, while giving an imprecise recognition to the effects of inflation on an investment. Real estate tends to be a very illiquid investment, so it was particularly important to the holders of real estate that some means of recognizing the impact of inflation would be available. The repeal of the capital gains exclusion in 1986 destroyed even that

imprecise mechanism. Lower tax rates simply did not mitigate the impact of removing the exclusion. Virtually any Realtor® you might meet would have plenty of stories to tell about properties that would have sold, except that the tax beating of current law was simply too great.

Since 1986, we have sought a restoration of a meaningful capital gains differential. We have not been wedded to any particular method. In addition, we have consistently supported even the complexities of indexing in order to reflect more accurately the real economic gain on the sale of a real estate investment. Thus, we certainly support the capital gains scheme implicit in the Clinton Administration's changes to the tax rate structure. To the extent that an individual is in the 31%, 36% or surtax brackets, the decision to leave the 28% cap on capital gains taxes, and to make no other structural changes to the capital gains scheme is a good decision. The National Association of Realtors® supports that result.

We are hopeful, however, that the Committee will review the impact of that decision. A capital gains differential will not be available to families with less than about $85,000 of taxable income. A significant volume of capital gains transactions occurs for individuals in that income category, even though the dollar amount is relatively small. Many of those taxpayers will have only a limited number of capitals gains transactions in a lifetime, yet their limited number of assets will be taxed less advantageously that the larger, diversified portfolio of an upper income individual. This anomaly does not cause us to withdraw our support for the capital gains provision that the Administration has proposed, but we do express our desire that the Committee examine the fairness of creating two classes of taxpayers -- those with a capital gains differential, and those without a differential.

ITEMIZED DEDUCTIONS

When President Clinton called business leaders together in mid-February to describe his economic plan to them, he enumerated three factors that were helping to stabilize and improve the economy. One of these was an improved housing market, driven primarily by the lowest interest rates in 20 years. We agree with him that the market is improving in many places, and we are delighted with the current interest rates. We also agree with his implicit conclusion that real estate can help lead the economy out of recession. After all, between 15 and 20 percent of gross domestic product is real estate-related. We must point out, however, that this performance in the housing markets is still shaky, and that negative signals could have a very damaging effect. In our view, any real or perceived threat to the mortgage interest deduction would send a disastrous signal into the market.

We must reiterate to this Committee that we will oppose direct and indirect attacks on the mortgage interest deduction. We urge the Committee to follow the Administration's lead in avoiding any temptation to limit the deduction. While we expressed our displeasure with the cap that was imposed on mortgage interest in 1987, we nonetheless deeply appreciate Chairman Rostenkowski's leadership in holding the line on that cap. We opposed the 1990 budget agreement that created the so-called "Pease" limitations, and find this kind of backdoor rate increase particularly odious. Similarly, our grass roots rallied in just the last two weeks to oppose the Senate Budget Committee's attempts to instruct the Finance Committee to limit itemized deductions. We therefore again urge this Committee to follow the lead of the President and to recognize that the real estate industry can lead the nation's economic recovery, and to preserve the environment in which that recovery can occur.

CONCLUSION

We believe that the Clinton Administration has proposed a useful, well balanced real estate tax package. It is important that we act on this package quickly. The real estate provisions break no new ground, inasmuch as they are nearly identical to the real estate provisions that passed Congress in 1992. These provisions have the full support of a coalition of real estate trade associations that has sought legislative changes for several years. This coalition has worked in a collegial way with the two tax writing committees, and has demonstrated its willingness to live within the constraints of the budget process and to resolve technical and revenue problems in a constructive manner. We urge you to move forward, and will be happy to work with you to achieve our mutual goals.

Mr. MATSUI. I would like to thank all six members of the panel. I just have a very few questions.

First of all, Mr. Elrod, I do want to thank Mr. Giovaniello, a member of your staff who has given me a copy of the Realtor News dated March 12 of this year, and it does indicate your association's general support of the administration's program, and we really appreciate that.

I might just point out to all the members of this panel and others that were before you that this is going to be a very, very difficult vote for Members on the Floor, because of the combination of spending cuts and tax increases in this package.

So we would hope that you will really mobilize your membership once you had an opportunity to review the reconciliation package. I am afraid that if it goes down many of the provisions you are advocating, including the passive loss, extender of provisions and many others, could be lost in the shuffle, and it would be probably years before they will come back.

Because this is a big revenue package, as you know, there is better opportunity to put in items like passive losses, extension of low-income housing credits, enterprise zones, and whatever else. But if it were a very narrow package, as you all well know, then you fight the constant problem of revenue offsets.

So I think this is one opportunity for business and industry to get behind a package in which many of the items that you have been wanting over the last—well, since 1986, when tax reform passed—are included.

I would like to ask Mr. Glunt a question because I think you raised a very interesting observation with respect to the enterprise zones and putting incentives in for real estate investment and rehabilitation in enterprise zones. And I think it makes a lot of sense. If one believes you have enterprise zones for the purpose of rehabilitating the neighborhood or a community or a section of a community, why not housing? Is that an issue you have explored? Is there some interest in that beyond your comments today, Mr. Glunt?

Mr. GLUNT. Yes; we are very interested. We certainly support the concept of enterprise zones. And if we are bringing business into a community, we think that a way to attract business is to have housing for the people that work in those particular communities. And we just feel that the enterprise zone concepts would make a lot more sense if we truly do have a housing component and this is a part of it.

Mr. MATSUI. Thank you.

One question—any one of the panel members can respond to this. As you all know, I have supported the passive loss relief ever since Mr. Andrews introduced his bill, I believe, 4 years ago. And even during the tax reform debate in 1985 when it was in the House we did maintain some level of passive loss deductions. It was in the Senate where they pared down the proposal, and then the House and Senate conference where it was eliminated completely because of the desire to lower rates even beyond what we had lowered them to.

But one of the concerns I think that was raised back in 1985, if I recall the debate, was that passive losses combined with a capital

gains differential creates the problem of tax shelters. If you recall, one of the reasons I believe the industry—real estate industry was hit so hard during tax reform was because there were so many stories about the tax shelters. And, of course, we don't want that to come back. I don't think your industries would want that to come back either because, undoubtedly, if it does, there will come a time some time in the 1990's when you will be slapped again. I don't think we want to go through that because I think some of the provisions previously enacted were overly stringent, and we may have had an impact, an adverse impact on the industry as a result of some of the things we did.

But currently there is a proposed 12-percent differential for people in some income groups because of the 28-percent capital gains rate. The proposal includes an increase in the individual rates from 31 to 34 percent. And then, if you include the Pease amendment, the surtax and the phaseout of the personal exemption, the rate could go all the way up to approximately 40 percent, causing almost a 12-percent differential in some cases. The administration indicates that this was intentional on their part. They deliberately left the capital gains rate at 28 percent.

There is some interest on this committee to review and examine that. Does anybody have an opinion on that?

Mr. WECHSLER. Mr. Chairman, when you go back and look at the history of the last decade in terms of real estate and tax policy, one of the critical issues, given the concern that I think both the committee and the industry has about tax shelters in general—because it was not a happy experience for our industry and our community, and it helped drive us to where we are today—is the fact that, in 1981, much of what drove this tax sheltering was very accelerated real estate depreciation, set at 15 years.

We are moving on a continuum, as we for straight-line real estate discussed here today, that has now gone to 31½ years depreciation. The President's proposal taxes it to 36 years. Last year, in H.R. 11, the vetoed tax bill it was set at 40 years. And when you are talking about depreciation at those rates, which amount to economic depreciation, the potential for tax sheltering is vastly reduced if not eliminated.

As far as the capital gains differential, when Secretary Bentsen testified he indicated, as you have echoed, that it was an intentional part of the administration's plan to have a differential, and that it was an investment-oriented provision which I think certainly could be positive for real estate values. And I don't believe it would lead to tax sheltering per se, particularly with the passive loss rules applying generally to those who don't materially participate in the business. The passive loss rule changes we've talked about today would only allow those who materially participate in the business to take deductions for operating expenses, such as heating and cooling the building and for paying banks' interest and for economic depreciation. So I don't see it as a problem.

Mr. MATSUI. Anybody else have a comment or thought on that?

OK, one last question. I think other panelists may have discussed this, but just for the record, perhaps Ms. McFall or Mr. Dwars could comment on mortgage revenue bonds.

Obviously, you need a permanency factor. How devastating has the lack of permanency of this program been to your industry?

Ms. McFall. I would be happy to comment on that, having presided over—I directed the Maryland agency for 12 years so I have been through every one of these gaps.

And it is extraordinarily difficult to manage and operate programs that take advantage of the correct conditions in the bond market and meet the needs of the low-income people and the private banks who originate mortgages for us with this off and on again, fits and starts. We have learned over the years to adjust with various kinds of escrow financings and other things, but they are very inefficient.

I think at the core the real problem is the families who get on waiting lists and then we have an expiration and another gap and long waits and, of course, contracts on homes that don't stand still and a very limited supply of affordable housing so that they may lose that home and never find another one that is suitable to their purpose.

So there isn't anything dearer to our hearts, as you know, than a permanent extension for enabling us to run consistent and efficient programs for the low-income housing program.

Mr. Matsui. Thank you.

Mr. Coyne, will you inquire?

Mr. Coyne. No questions.

Mr. Matsui. I would like to thank the members of the panel for testifying and appearing today. Even though there are not many members here today, the staff is here, and they the ones that are going to help us with the legislation, and so your points of view were well taken and certainly will be considered by the members of the committee. So thank you very much. I appreciate it.

This hearing is adjourned to be reconvened on March 31 at 10 a.m.

[Whereupon, at 2:45 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, March 24, 1993.]

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

WEDNESDAY, MARCH 31, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order.

Today, we continue our series of hearings on the President's package of deficit reduction and public investment provisions. In today's hearings, we will hear from several business associations, corporations, and public interest groups on a variety of topics.

First, we will hear from a panel of witnesses concerned about the proposed increases in tax rates applicable to business taxpayers. Second, we will hear from a panel that includes the hotel, restaurant and entertainment industries. Following that panel, we will hear from organizations representing a variety of viewpoints, some critical and others supportive of the President's various tax proposals. Not surprisingly, we will hear strong testimony in support of extending the various expiring tax provisions and equally strong criticisms of many revenue raising provisions.

To those of you who would be critical of specific revenue raising components of the President's package, I would ask that you be prepared to suggest revenue raising alternatives. When this committee meets to mark up the President's package as part of the budget reconciliation process, we will be required to meet a specific deficit reduction goal.

Mr. Archer.

Mr. ARCHER. Mr. Chairman, thank you very much.

I just want to add my welcome to the two gentlemen on the panel leading off this morning. I cannot help but also add that if you have got any spending reductions to reduce some of these tax increases that would qualify, this committee will be happy to have those, too.

Chairman ROSTENKOWSKI. We will now begin with our first panel of witnesses.

Mr. Sydnor, will you start, please?

STATEMENT OF GEORGE W. SYDNOR, JR., CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, AND PRESIDENT AND CHIEF OPERATING OFFICER, JAMES McGRAW, INC., RICHMOND, VA

Mr. SYDNOR. My name is George Sydnor. I am president of James McGraw, Inc., of Richmond, VA, a distributor of industrial equipment and supplies to the manufacturing sector.

I am here today as chairman of the board of NAW. NAW was a founding member of TRAC, whose testimony you will hear shortly.

I want to commend you, Mr. Chairman, for the extraordinary effort the committee undertook in 1986 to produce a truly historic piece of legislation, despite tremendous political pressure from political interests and special interests. Reform of our tax system would never have occurred, without your stalwart leadership, your determined persistence and your clear vision.

Before 1986, the tax system had grown grossly unfair. The numerous preferences which complicated the code created very wide disparities in the effective tax rates paid by various industries. NAW considers the Tax Reform Act of 1986 to be the most important piece of tax legislation passed in the 47-year history of our organization. Because market forces, rather than public policy, no matter how skillfully crafted, can best determine investment decisions, we strongly urge you to preserve the act's principles.

Today, the President has successfully focused the public's attention at long last on the vital need for deficit reduction. We applaud him for his efforts. NAW has always believed, however, that cuts in Federal spending must be the core element of deficit reduction.

Unfortunately, in our view, the package which is before the Congress today relies far too heavily on tax increases and far too lightly on spending reductions. We know of no example in history where a country has successfully taxed its way to job growth and prosperity. We worry that the President's tax increase proposals will stall, if not smother, the economic recovery.

In the brief time we have, let me focus on two of our main concerns. First, the President's package attacks the philosophical underpinnings of the 1986 act. It begins a return to a system filled with shelters, loopholes and preferences. It will seriously disrupt the level playing field created in 1986.

To pay for preferences such as the temporary investment tax credit for the chosen few, the package would increase the top corporate rate, taking vital funds out of the economy which would be used for investment and job creation. In my own company's case, as we try to assess the full impact of the tax increases in the President's proposal, I have been compelled to instruct all of our managers to put a hold on proposed new spending.

The proposed temporary incremental ITC is, in a word, "anemic," that will be of only marginal utility to us. Prior to 1986, I was an avid fan of the investment tax credit. Our customers used it to our advantage, and I was deeply concerned when it was repealed. Since 1986, however, we have come to appreciate the value of lower corporate rates that were put in place in lieu of the ITC.

Just as we opposed the Bush administration's efforts to obtain a capital gains differential at the expense of rates, we urge this com-

mittee today to scrap the proposed temporary ITC and, in return, leave the corporate rate untouched.

A second concern we have is with the proposed increase in the personal rates and the impact these increases will have on subchapter S corporations, partnerships and sole proprietorships, which are the job creating engines of the economy.

Mr. Chairman, there are some 1.4 million subchapter S corporations in America. The impact of the President's tax increase proposals on these firms needs to be understood and addressed.

In conclusion, Mr. Chairman, when the Tax Reform Act of 1986 was finally enacted, you hung a sign on your door which simply said "Gone Fishing," which was in our mind a very symbolic move. It said loudly and clearly that the Ways and Means Committee had performed heroic work with the landmark 1986 act and now it was time to pursue other business. That also said, equally loudly and clearly, let's let the ink stay dry on the Tax Code.

From a businessman's perspective, Mr. Chairman, I really wish you could hang that sign up again, and I have brought you a new one today for that purpose.

Thank you for allowing NAW to appear this morning.

[The prepared statement and attachments follows:]

Statement of

GEORGE W. SYDNOR, JR.
CHAIRMAN OF THE BOARD
NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Before the

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

on

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

March 31, 1993

INTRODUCTION

My name is George Sydnor. I am President and Chief Operating Officer of James McGraw, Inc., of Richmond, Virginia, a distributor of industrial equipment and supplies to manufacturers. Our company was established in 1866 -- over 125 years ago. Our sales volume of $40 million places us in the top 50 industrial distributors nationally, underscoring that ours is an industry preponderantly comprised of small to medium-sized companies. Our approximately 2,800 customers range from independently-owned machine shops to multinational and Fortune 500 corporations.

I am also Chairman of the Board of the National Association of Wholesaler-Distributors (NAW), and it is in that capacity that I appear today.

I want to point out that NAW was a founding member of the Tax Reform Action Coalition (TRAC), whose testimony you have already heard this morning.

At the outset, I want to commend you, Mr. Chairman, as the TRAC witness did, for the extraordinary effort this Committee undertook in 1986 to produce a truly historic piece of legislation, despite tremendous political pressure from special interests. Reform of our tax system would never have occurred without your stalwart leadership, your determined persistence, and your clear vision of what the tax code should ultimately contain. NAW salutes you again today as we did in 1986 for creating a tax code which greatly reduced preferences, enabling rates to be lowered. By so doing, you eliminated substantial bias in the code which favored one industry over another and which distorted investment decisions.

THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS AND THE WHOLESALE DISTRIBUTION INDUSTRY

NAW is a federation of 110 national wholesale distribution trade associations (a list is attached as APPENDIX A). NAW represents approximately 40,000 companies with 150,000 places of business. These firms range in size from

those with less than $1 million in annual sales to those with over $13 billion. The typical firm has approximately $5-$10 million in sales and employs 30-50 individuals.

Wholesale trade is an enormous and economically potent industry with annual sales in excess of 3.1 trillion dollars. NAW represents the merchant wholesale distribution industry, the largest segment of wholesale trade.

THE PREVIOUS TAX CODE'S DISCRIMINATORY EFFECTS ON THE WHOLESALE DISTRIBUTION INDUSTRY

Prior to enactment of the Tax Reform Act of 1986, the tax system was grossly unfair. The numerous deductions, exclusions and credits which complicated the tax code created very wide disparities in the effective tax rates paid by various industries, and even by companies within those sectors.

Some taxpayers were able to sharply reduce their tax obligations through tax credits and deductions while a similar capability was denied to other taxpayers with comparable taxable income simply because they were in a business where the activities needed to trigger the use of preferences were of secondary importance, at best, to their direct business operations.

For instance, labor and inventory-intensive industries, like wholesale distribution, made relatively nominal use of most of the previous code's capital cost recovery provisions which enabled other industries with similar net taxable income to pay much lower rates of tax on similar levels of operating income. The reason for this, in the case of our industry, is that 80 percent of the typical wholesaler-distributor's assets are in inventory and accounts receivable, not in capital assets.

The result was a tax subsidy for certain types of business activity and investment at the expense of high effective rates paid by others. Indeed, studies conducted by the Joint Committee on Taxation found that the wholesale distribution industry paid either the highest or the second highest effective tax rate of the industries studied -- approximately 35 percent in 1983, for example.

NAW'S SUPPORT FOR TAX REFORM

NAW's decision to support the principles of tax reform in 1986 was not made in a vacuum. In 1985, NAW commissioned a study by Arthur Andersen & Company, which analyzed the actual tax returns of wholesaler-distributors against the Treasury Department's November, 1984 and May, 1985 tax reform proposals. The study came to two important conclusions: first, the proposed reduction in tax rates would offset the loss of preferences in prior law; and that the proposal would reduce the disparity in effective rates between wholesaler-distributors and other industries, thus creating a more level playing field.

This is not to imply that the exchange of tax preference for lower rates was an easy one for many wholesaler-distributors to make. Indeed, the changes made by the '86 Act in inventory cost capitalization were of significant specific cost to wholesaler-distributors. However, it was NAW's and the wholesale

distribution industry's strongly held belief that a significant reduction in corporate and individual tax rates outweighed these factors. Central to this conclusion was our belief that market forces, rather than public policy, no matter how skillfully crafted, can best determine investment decisions.

Of identical import is that retained earnings are the principal and often sole source of growth capital for small, entrepreneurial businesses. The increase in retained earnings generated by the Tax Reform Act of 1986 for many wholesaler-distributors translated into more investment in jobs, inventory, warehouses, computers, delivery trucks and services.

NAW considers the Tax Reform Act of 1986 to be the most important piece of tax legislation passed in the 47-year history of our organization. We strongly urge you to preserve its principles as you move to meet the requirements of the budget resolution.

THE PRESIDENT'S PROPOSALS

As this Committee begins its work on the proposals which President Clinton has made, we all recognize that today's environment is far different from that of 1986. The President has successfully focused the public's attention at long last on the vital need for deficit reduction and is waging a superb campaign to keep that goal readily in sight. We applaud him for his efforts, and our members are eager to work with him to achieve meaningful reductions in our annual Federal deficits and our massive national debt.

As ever, however, the "devil is in the details." NAW has always believed that cuts in Federal spending must be the core element of deficit reduction. We hold that same belief today. Unfortunately, in our view, the package which is before the Congress today relies far too heavily on tax increases and far too lightly on spending reductions. For business, taxes will rise by some $170.1 billion under the President's plan. Proposed business incentives will total only $56.5 billion. So, business taxes would increase by a net of some $113 billion. In total, taxes will rise by $246 billion -- the largest tax increase in U.S. history. We know, Mr. Chairman, of no example in history where a country has successfully taxed its way to job growth and prosperity.

Beyond this obvious concern lie some deeper and darker problems. Others who have appeared before this Committee, like our colleagues at the National Association of Manufacturers, have clearly identified many of the concerns which affect businessmen and women across the broad spectrum of our economy.

From an NAW perspective, let me focus on three of our main concerns:

First, and perhaps foremost, the President's package attacks the philosophical underpinnings of the Tax Reform Act of 1986. It begins a return to a tax system filled with shelters, loopholes and preferences. It will seriously disrupt the level playing field created in 1986. To pay for those "benefits" such as the temporary investment tax credit for the chosen few, the package would increase the top corporate income tax, taking vital funds out of the economy which would be used for investment and job creation.

In my own company's case, as we assess the full impact of the tax increases in the President's proposal, I have been compelled to instruct all of our managers to put a hold on proposed new spending. Depending on the shape of the final legislation which is enacted, it is possible, my financial officers tell me, that we may need to lay off some employees -- instead of hiring the new ones called for in our current strategic plan.

Prior to 1986, I was an avid fan of the Investment Tax Credit. Our customers used it to our advantage, and I was deeply concerned when it was repealed. Since 1986, however, we have learned to live well without it and have come to appreciate the lower corporate rates which we acquired in lieu of the ITC. We have taken a look, as best we can, at the proposed temporary, incremental ITC -- and we find it, in a word, "anemic." While we cannot analyze it thoroughly until Treasury enlightens us more on the way it would work in the real world with all of its restrictions and recapture provisions, we already believe from what we do know that it will be of only marginal utility to us.

I never thought I would ever hear myself say this, Mr. Chairman, but I urge you to scrap the proposed temporary ITC and, in return, leave the top corporate rate untouched. This is a far better approach.

As regards the proposed permanent small business ITC, if you determine that special incentives should be provided to such businesses, we suggest that you simply increase the amount of capital investment that a small business can expense rather than depreciate above the current $10,000 level. And, if jobs creation is the objective, many small business owners would favor a jobs tax credit, instead of the small business ITC.

A second concern we have is with the proposed increase in the personal rates. The proposed new top rate of 36% and the additional 10% surtax on certain taxpayers is being sold as a way "to soak the rich" and bring "fairness" to the tax code. I understand the rhetoric. I do not, however, understand why no attention seems to be paid to the impact of these increases in the individual rates on Subchapter S corporations, partnerships, and sole proprietorships which are the job-creating engine of the economy.

One of our members, a distributor in Baltimore and a constituent of Mr. Cardin, recently wrote a very thoughtful letter to the Congressman on the Subchapter S penalties inherent in the President's proposal. The entire letter is attached to this statement as APPENDIX B, but let me quote the substance of two paragraphs at this time:

> *"Virtually all of the job growth in the economy in the past ten years has come from small businesses. When the ... (1986) Tax Reform bill was passed by Congress and signed by President Reagan, it provided two resources to small businesses. The first was time. With all of the loopholes, special interest breaks and tax traps eliminated, we could take the 30-50% of our time that had previously been spent on tax reduction and devote that to growing our businesses. The second is obvious and that was cash. By reducing the marginal tax rates and allowing us to use S Corporation taxes, we responded by investing in and growing our businesses and, correspondingly, increasing our employment. If you pass the 45.4% increase in taxes on S Corporation owners, you take back a lot of the cash. As our cash is reduced, our ability to*

invest and grow is reduced, and the rate of job creation will also be reduced . . . . I sincerely believe that this tax proposal will have a large negative effect on the small business sector and its investment and employment growth.

"Clendenin Brothers has just completed the purchase of a new building . . . . This building will give us access to more than twice the space we now occupy. The new tax proposal has already had an impact on our expansion plans and will continue to do so if it is passed as is. We had initially planned to replace the entire roof and install a new heating system. These expenditures would have cost about $500,000 and would have been placed with contractors in the area. We are now debating whether we can just maintain the roof for a while and live with the minimal new heat plant, lowering the cost to about $50,000. We are rapidly losing our enthusiasm for vigorous expansion and investment and turning to caution, conservative investment and cost control. I do not think we are the only ones."

Mr. Chairman, there are 1.4 million Subchapter S corporations in America according to *The 1989 IRS Statistics of Income* -- the most recent compilation available. I do not have a definitive solution to suggest for resolving the impact of the President's tax increase proposals on these firms, but I respectfully urge that one be found. To raise their taxes by the staggering percentages which are proposed will destroy, not create, jobs.

Our third concern is what we believe will be the negative effect of the total package on the economy.

I fear that the President's tax increase proposals will stall, if not stifle, our economic recovery. That would be just the opposite of what the President seeks and what all of us in this room desire -- but I truly fear it could well happen. I guess I have yet one further thought -- a question, if you will -- if the economy does stall, will we then need to prime the pump to get it moving again, and thereby say good-bye to all hope of deficit reduction? As I hold my wallet, I do so with my fingers tightly crossed.

CONCLUSION

Mr. Chairman, as I recall the stories, when the Tax Reform Act of 1986 was finally enacted, you hung a sign on your door which said simply: "GONE FISHING." It was, in my mind, a very symbolic move. It said, loudly and clearly, I think, that the Ways and Means Committee had performed heroic work with the landmark '86 Act and now it was time to pursue other issues. It also said equally loudly and clearly -- let's let the ink stay dry on the tax code! From a businessman's perspective, Mr. Chairman, I fervently wish you could hang that sign up again today.

Thank you for allowing NAW to appear this morning.

Attachments:
APPENDIX A
APPENDIX B

APPENDIX A

National Wholesaler-Distributor Organizations Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers Association
American Machine Tool Distributors Association
American Supply Association
American Traffic Safety Services Association, Inc
American Veterinary Distributors Association
American Wholesale Marketers Association
Appliance Parts Distributors Association, Inc
Associated Equipment Distributors
Association for Suppliers of Printing & Publishing Technologies
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc
Bicycle Wholesale Distributors Association, Inc
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Copper & Brass Servicenter Association
Council for Periodical Distributors Association

Electrical-Electronics Material Distributors Association
Engine Service Association, Inc.

Farm Equipment Wholesalers Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Food Marketing Institute
Foodservice Equipment Distributors Association

General Merchandise Distributors Council

Health Industry Distributors Association
Hobby Industries of America

Independent Medical Distributors Association
Independent Sealing Distributors
Independent X-Ray Dealers Association
Industrial Distribution Association
International Association of Plastics Distributors
International Hardware Distributors Association
International Sanitary Supply Association
International Truck Parts Association
International Wholesale Furniture Association
Irrigation Association

Jewelry Industry Distributors Association

Machinery Dealers National Association
Material Handling Equipment Distributors Association
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors, Inc.
National Association of Floor Covering Distributors
National Association of Flour Distributors, Inc.
National Association of Hose and Accessories Distributors
National Association of Meat Purveyors
National Association of Recording Merchandisers
National Association of Service Merchandising
National Association of Sign Supply Distributors
National Association of Sporting Goods Wholesalers
National Association of Wholesale Independent Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Independent Poultry and Food Distributors Association
National Industrial Glove Distributors Association
National Insulation and Abatement Contractors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
Northamerican Heating & Airconditioning Wholesalers Association
North American Horticultural Supply Association
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute
Suspension Specialists Association

Textile Care Allied Trades Association

United Products Formulators & Distributors Association

Wallcoverings Association
Warehouse Distributors Association
for Leisure and Mobile Products, Inc.
Water and Sewer Distributors of America
Water Systems Council
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association, Inc.
Wine & Spirits Wholesalers of America, Inc.
Woodworking Machinery Distributors Association
Woodworking Machinery Importers Association

National Association of Wholesaler-Distributors
1725 K Street, NW, Washington, D.C. 20006 • 202/872-0885

3/18/93
110 Member National Associations

APPENDIX B

CLENDENIN BROTHERS, INCORPORATED
Manufacturers Established in 1885

John C. Corckran, Jr.
Chief Executive Officer

COPY

February 26, 1993

The Honorable Benjamin L. Cardin
U. S. House of Representatives
227 Cannon Office Building
Washington, DC 20515

Dear Congressman Cardin:

Thank you for the positive response you gave when I called your attention to the inequitable tax load being placed on small businesses in the current tax proposal. As I told you, I was not calling on you attempting to say, "Please do not raise my taxes.", because that issue was clearly settled in the Presidential election. What I did point out was that, including the Bush tax increases, small business taxes (more specifically, S-Corporations) will have been increased from 28% to 40.7% if the President's proposals are enacted as they have been proposed. This is a 45.4% increase.

First, let me reiterate how I reach 40.7%, since that differs somewhat from published reports. The Bush increases raised the top rate to 31%, plus it reduced standard deductions by 3%, which is essentially a 1% additional tax (32%). The Clinton Proposal would increase the top rate to 36%, plus the 1% tax added by standard deduction limitations (37%). Add a 10% surtax and you get 40.7%.

The effects of a 45.4% increase in our taxes will have serious effects on the S-Corporations my brother and I control and on the economy as a whole. Since I told you I was not merely asking you to not increase my taxes, I will focus on my analysis of its' negative effects on the economy as a whole first.

Virtually all of the job growth in the economy in the past ten years has come from small businesses. When the Bradley-Gephardt Tax Reform bill was passed by Congress and signed by President Reagan, it provided two resources to small businesses. The first was time. With all of the loopholes, special interest breaks and tax traps eliminated, we could take the 30-50% of our time that had previously been spent on tax reduction and devote that to growing our businesses. The second is obvious and that was cash. By reducing the marginal tax rates and allowing us to use S-Corporation taxes, we responded by investing in and growing our businesses and, correspondingly, increasing our employment. If you pass the 45.4% increase in taxes on S-Corporation owners, you take back a lot of the cash. As our cash is reduced, our ability to invest and grow is reduced, and the rate of job creation will also be reduced. If the tax law passes as is, and many of us are forced back into C-Corporation status, you take back the time as well, since the biggest tax trap is doing something that the Internal Revenue Service could call a dividend. I sincerely believe that this tax proposal will have a large negative effect on the small business sector and its' investment and employment growth.

Clendenin Brothers, Incorporated is in your district. My brother Jim and I both live in your district and I would guess that most of our employees live in the district as well. Our great-grand uncles started in business in 1865 as copper merchants when Baltimore had many copper refineries. The refineries have disappeared and we have switched our emphasis to aluminum. Three generations before us have deferred consumption, saving and investing in the future, and we are doing the same thing. To us, long-term does not mean six months, it means two more generations. Clendenin invested more in new plant and equipment in the 1980's than in its' entire previous history. We are doing our job. The number of employees in companies controlled by my brother and myself has increased from less than 150 to more than 450. Out of curiosity, I looked up our 1982 tax returns. For 1992, we will pay substantially more to the United State Government than we paid in 1982, in spite of the reduction in marginal rates. We will also pay more to the City of Baltimore and to the State of Maryland.

Clendenin Brothers has just completed the purchase of a new building in the City. This building will give us access to more than twice the space we now occupy. The new tax proposal has already had an impact on our expansion plans and will continue to do so if it is passed as is. We had initially planned to replace the entire roof and install a new heating system. These expenditures would have cost about $500,000 and would have been placed with contractors in the area. We are now debating whether we can just maintain the roof for a while and live with the minimal new heat plant, lowering the cost to about $50,000. We are rapidly losing our enthusiasm for vigorous expansion and investment and turning to caution, conservative investment and cost control. I do not think we are the only ones.

I think you agree that the proposed increase in taxes on S-Corporation owners is inequitable. I am grateful for your commitment to take the lead in trying to find a way to correct this inequity without damaging the Plan that the President has proposed and the majority of Americans appear to support. I also do not believe that the President or his advisors were aware of the extreme penalty placed on small businesses by his plan and that, if they were made aware, they would also support some form of relief. I sincerely believe that the macro-economic effects of that aspect of the tax plan will be damaging to the economy and employment growth. I will be available to give you all of the support that you or David may request. Again, thank you very much for taking the time to meet with me and for your positive response.

Sincerely yours,

John C. Corckran, Jr.

JCC:mja

cc: David Koshgarian
Dirk Van Dongen,
President, National Association of Wholesaler-Distributors

Chairman ROSTENKOWSKI. Thank you.
Mr. Sullivan.

STATEMENT OF HARRY SULLIVAN, COCHAIRMAN, TAX REFORM ACTION COALITION, AND SENIOR VICE PRESIDENT AND GENERAL COUNSEL, FOOD MARKETING INSTITUTE

Mr. SULLIVAN. Good morning, Mr. Chairman and members of the committee.

My name is Harry Sullivan. I am the senior vice president and general counsel of Food Marketing Institute. I am also here today as cochairman of the Tax Reform Action Coalition, and it is in that capacity that I testify.

Prior to the enactment of the Tax Reform Act of 1986, very wide disparities existed in the effective tax rates paid by different economic sectors and even by individual firms within the same sector. While some businesses could substantially reduce their tax obligations through credits and deductions, others with the same taxable income could not, because the activities which qualified for those credits were not a significant part of their natural business operations.

The Tax Reform Action Coalition was formed in June 1985 by business associations and corporations which were committed to enacting Federal tax reform which would substantially reduce the then existing high statutory individual and corporate tax rates in return for the reduction of preferences in the code.

The coalition's membership grew rapidly, and by the time tax reform was enacted, TRAC's membership had grown to 250 corporations and associations. All told, the coalition's membership represented more than 100 of the Fortune 500 companies and over 1 million businesses nationwide. Today, TRAC is even more broad-based, with 339 association and corporate members, and a current membership roster is attached to my written statement.

TRAC enthusiastically supported the 1986 act, because of the substantial reduction in marginal tax rates which the act provided in return for base broadening. This was both a fair and a desirable compact. Throughout the process, TRAC focused solely on the issue of tax rates, and the coalition retains that focus today.

Mr. Chairman, as you and members of the committee so well know, TRAC worked closely with this committee to enact what was one of the most significant pieces of legislation in modern political history. The Tax Reform Act of 1986 represented much more than a revamping of the Tax Code. It represented a victory of principle over special interests and demonstrated that American politics can work to the benefit of all of the people, not just a chosen few.

Mr. Chairman, your determined dedication at tax reform from the nationally televised address asking Americans to "write Rosty," to the eventual signing in the Rose Garden, your dedication was one of the most important contributions any single individual has made to American tax policy.

As the committee begins its consideration of the tax components of the President's proposals, it is important to remember that the core of tax reform was the shift of investment decisions to an economically motivated basis from a tax motivated basis.

The President's proposals reflect a reversal of the stunning achievements of the 1986 act, namely, restoration of special preferences and an increase in the tax rates. This tears at the fiber of tax return. It will recreate the unfairness and the inefficiency of the pre-1986 law.

TRAC strongly urges the committee to not do this. In furtherance of this viewpoint, we urge you to abandon the proposed temporary investment tax credit and leave corporate tax rates alone. The temporary ITC has virtually no support in the business community. Retaining the corporate tax rate at its current level certainly does.

TRAC wishes to further note that the increase in individual rates will also have a devastating effect on businesses which pay taxes as individuals. Many of these businesses are small- to medium-size enterprises that have provided the largest share of new jobs in the country over the past 10 years. This increase in their taxes will seriously undermine the ability of small business owners to reinvest the profits from fledgling enterprises and create new jobs and grow. Indeed, in many respects, smaller businesses are the hardest hit by the President's proposals.

In conclusion, TRAC supported the 1986 Tax Reform Act, because of the rates it contained and the promises that those rates held for sound economics and tax equity. We supported base-broadening through the elimination of preferences. These are the linchpins of the 1986 compact. With profound respect for the landmark legislation, we strongly urge you not to increase rates and not to restore preferences.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

Statement of

HARRY SULLIVAN
CO-CHAIRMAN
TAX REFORM ACTION COALITION

Before the

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

on

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

March 31, 1993

INTRODUCTION

Good morning, Mr. Chairman and members of the Committee. My name is Harry Sullivan. I am Senior Vice President and General Counsel of the Food Marketing Institute (FMI).

FMI is a nonprofit association conducting programs in research, education, industry relations and public affairs on behalf of its 1,500 members -- food retailers and wholesalers and their customers in the United States and around the world. FMI's domestic member companies operate approximately 19,000 retail food stores with a combined annual sales volume of $190 billion -- more than half of all grocery store sales in the United States. FMI's retail membership is composed of large multi-store chains, small regional firms and independent supermarkets. Its international membership includes 250 members from 60 countries.

I am appearing here today as a Co-Chairman of the Tax Reform Action Coalition (TRAC), of which FMI is a founding member.

GENESIS OF THE TAX REFORM ACTION COALITION (TRAC)

Prior to the enactment of the Tax Reform Act of 1986, the numerous deductions, exclusions and credits which complicated the tax code were used as tools to influence so-called "economic" decisions. However, over time the accumulation of special tax relief and preference provisions resulted in a highly uneven and economically counter-productive distribution of "benefits" among taxpayers and various types of economic activities.

Wide disparities were created in the effective tax rates paid by different economic sectors, and even by individual firms within the same sector. While some businesses could substantially reduce their tax obligations through preferential tax credits and deductions, a similar opportunity was not available, as a practical matter, to others with the same income, because the activities which generated these credits were not a significant part of their natural business endeavors.

As a result of these disparities in the Tax Code, the Coalition to Reduce High Effective Tax Rates was formed in 1983. The Tax Reform Action Coalition (TRAC) evolved, in turn, from this coalition. TRAC was initially formed in June of 1985 by six business associations and corporations which were committed to enacting federal tax reform legislation to substantially reduce the then-existing high nominal individual and corporate tax rates in return for the reduction of preferences in the code.

The Coalition's basic objective resonated powerfully within the business community and membership grew rapidly. By the time the Tax Reform Act of 1986 was enacted, TRAC's membership had grown to 250 individual corporations and associations. TRAC's membership came to include major manufacturers of products ranging from cars to electronic devices to computers, food products, clothing and petroleum products as well as major financial services and investment companies, major real estate developers, trucking companies, wholesaler-distributors, retailers, and a host of small businesses of all types. All told, the Coalition's membership roster represented more than 100 of the FORTUNE 500 industrial companies and over one million businesses nationwide. TRAC's membership demonstrated broad business support for fundamental tax reform, in a rather admittedly divided business community.

Today, TRAC is even larger and more broad based in its composition, with 339 associations and corporations as members. (A current membership roster is attached as APPENDIX A.)

TRAC enthusiastically supported the 1986 Tax Reform Act because of the substantial reduction in marginal tax rates it provided in return for base broadening. While the Act explicitly projected that large tax increases would be imposed on the business sector, as businessmen we nevertheless felt it constituted a fair and desirable compact and was worthy of support. Throughout the process, TRAC focused solely on the issue of tax rates and a broad base of income and the Coalition retains that focus today.

Following enactment of the 1986 Act, TRAC decided to remain organized as an action group to help insure, if necessary, that the rate reductions in the law would be implemented and maintained. Our decision was a prudent one, because over the past six years there have been many attempts to either delay the implementation of rate reduction, increase them, or impose surtaxes. And, today, as I appear before the Committee, the spirit and letter of the Tax Reform Act of 1986 has again been called into doubt.

Mr. Chairman, the Tax Reform Act of 1986 represented much more than a revamping of the tax code. It was a victory of principle over narrow special interests and demonstrated that American politics can work to the benefit of all of the people, not just a chosen few. There was no single person who was more instrumental to the success of this process than the Chairman of the Ways and Means Committee and tax reform had no stronger, nor more effective advocates than many of the members sitting on this Committee this very day.

In 1985, while we were still early in the tax reform process, TRAC received a letter from Chairman Rostenkowski. It said, in part:

> *"In my years in Washington, I have been exposed to hundreds of lobbyists pursuing their particular interests and numerous ad hoc coalitions created to work toward a shared goal. But TRAC is one of the few examples I've seen where the effort holds a clear public benefit. While TRAC members may be less than enthusiastic about*

> *particular portions of the tax reform bill, there seems a strong, public-supported commitment to support the whole. That's unusual -- and most welcome."*

Mr. Chairman, the encouragement and support you gave to TRAC made it possible for us to help you and the Congress to make tax reform a reality. And, we are here today to try to keep it a reality.

TRAC'S POSITION ON THE PROPOSED INCREASE IN TAX RATES

Since TRAC focuses only on rates, we have no position, as a coalition, on the President's overall economic plan. Individually, I certainly am prepared to assume that our members applaud and support the President's objective of significantly reducing the deficit. Again, individually, we may agree or disagree on various aspects of his plan other than those dealing with rates.

The President's economic proposal will increase the the top individual tax rate from 31 percent to 36 percent.and the top corporate rate from 34 to 36 percent. It would further impose a 10% surtax on certain individuals. Simultaneously, the proposal provides for the reinstatement of some tax preferences ostensibly in the interest of stimulating the economy in the short-term and keeping it growing over the long-term.

America's long-term economic growth is a matter of concern to all of us. It was in fact a conclusion of the 1985-1986 debate that a high rate, specially preferenced tax law had become a retardant of economic growth.

We feel it is critically important to remember that the most important aspect of what tax reform achieved was to cause investment decisions to be economically-motivated, not tax-motivated. Tax reform was enacted because the code was fundamentally unfair and inefficient and it treated taxpayers unequally by inducing investment decisions on the basis of tax, rather than economic considerations.

Our explicit and implicit understanding in working with this Committee was always that tax preferences had to be exchanged for lower rates, if the goals of reform were to be achieved. We supported this compact, and continue to do so. The President's proposals in their current form reflect the reverse of this, namely, a re-establishment of preferences and an increase in tax rates. Down that path lies both the unfairness and economic inefficiency of prior law.

It is also important to note that both the individual and corporate rate increases as proposed will dramatically increase business' tax burden. Under the proposal, the business burden alone will increase by a net $113 billion over the next five years -- reducing cash flow which is desperately needed in the private sector to create jobs and stimulate the economy.

Contrary to statements made by some advocates of an increase in the corporate tax rate, it is not correct that corporate America has not been paying its "fair share" of the tax burden. According to an analysis by the National Association of Manufacturers, corporations, in fact, paid an average effective tax rate of 32.5 percent in 1990, while individuals paid an effective rate of 10 percent. While the Tax Reform Act of 1986 was expected to and was adopted in the face of the calculation that it would shift $120 billion in tax burden from individuals to corporations over five years, these revenue expectations were not met for the simple reason that corporate income decreased or did not increase as projected during that period. The reason this occurred was not

because of the '86 changes in the code, but simply because corporate profits did not reach anticipated levels due to the recession. Corporate America does pay its fair share of the tax burden; in fact, it could be argued that it pays more than "a fair share."

Another argument used for increasing the corporate rate to 36 percent is that both individual and corporate rates need to be at the same level. Mr. Chairman, never in the history of the American income tax have the top corporate and individual rates been at the same level. Attached to our testimony as APPENDIX B is a chart derived from this Committee's publication, Overview of the Federal Tax System , which reveals the wide disparities over time between the corporate and individual tax rates. The historic disparity has ranged from 1 percent in 1909 (when individuals paid no income tax at all) to 64 percent in 1936. Indeed, the average spread between top individual and corporate rates over the life of the income tax is 31 percent. In 1991 and 1992, the corporate and individual top rate spread was 3 percent -- the closest the two rates have been in ten years, except for the transition year of 1987. We have heard no one arguing that the top corporate rate should be lowered so that it equalled the top individual rate. There is no good reason now to raise it to achieve a parity that has not been the historical case.

The five percent increase in the individual rates will have a devastating effect on businesses which pay taxes as individuals. It is important to remember that most of the businesses which pay taxes as individuals -- sole proprietors, partnerships or S Corporations -- are small to medium-sized businesses, which have provided the largest share of new jobs in the country over the past ten years. Additionally, small businesses which file as individuals must pay tax on what the businesses earn after deductions, not just on the business owner's personal income. This tax increase will seriously undermine the ability of a small business owner to reinvest the profits from a fledgling enterprise and create new jobs and reinvest new capital. The only advantage we can see to this staggering tax increase on small businesses is that new enterprises will be formed to assist taxpayers at finding new and innovative ways to evade paying the higher taxes they face through tax shelters.

CONCLUSION

TRAC supported the 1986 Tax Reform Act because of the rates it contained and the promise they held for economic and tax equity. We supported base broadening through the elimination of preferences. This compact was the linchpin of tax reform. With profound respect for this landmark legislation, TRAC strongly urges Congress not to increase rates and not to restore preferences.

In this regard, we have a specific recommendation to make: abandon the temporary ITC proposal -- it has garnered no support in the corporate community -- and leave the corporate rate at 34%. The President's package proposes business tax incentives costing $56.5 billion. It raises business taxes by $170.1 billion. This is a ratio of $3.00 in business tax increases for each $1.00 in proposed business tax incentives. The revenue loss associated with the temporary ITC is $9.1 billion. The revenue gain projected from the corporate rate increase is $30 billion. This is consistent with the 3 to 1 ratio which characterizes the President's overall proposal.

Thus, in proposing the trade-off outlined above, we believe that it is consistent with the President's logic to offset the full corporate rate increase with abandonment of the temporary ITC.

If you wish to establish a framework for jobs creation, you must, in addition, deal with the impact of the President's proposals on small businesses. In many respects, they are hit the hardest by the President's proposals.

Over a two-year period, Congress labored forcefully to produce the 1986 Tax Act. Cynics insisted that could never be done. Overcoming enormous odds, Mr. Chairman, you and the membership of this Committee did it. Increasing the rates now would at once shatter the compact Congress made with the American people.

TRAC urges this Committee, in the strongest possible terms, to reject the proposed increases in the top rates.

Attachments:
APPENDIX A
APPENDIX B

APPENDIX A

TAX REFORM ACTION COALITION (TRAC)

STEERING COMMITTEE

American Business Conference
American Dental Association
American Home Products Corporation
American Insurance Association
American Trucking Associations
Amway Corporation
Apple Computer, Inc.
BP America, Inc.
Beneficial Management Corporation of America
Citizens for a Sound Economy
Consolidated Freightways Incorporated
The Dial Corporation
Du Pont Company
E-Systems, Inc.
Electronic Industries Association
Eli Lilly & Company
Fleming Companies, Inc.
Florists Transworld Delivery Association
Food Marketing Institute
General Mills, Inc.
Georgia-Pacific Corporation
W R. Grace & Company
Grocery Manufacturers of America
Harris Corporation
Hershey Foods Corporation
Household International
I B M Corporation
International Mass Retailing Association
Kellogg Company
Kmart Corporation
The Kroger Company
Levi Strauss & Company
Merrill Lynch & Company
National-American Wholesale Grocers' Association
National Association of Chain Drug Stores
National Association of Wholesaler-Distributors
National Federation of Independent Business
National Restaurant Association
National Retail Federation
National Soft Drink Association
NYNEX
PepsiCo, Inc.
Pharmaceutical Manufacturers Association
Philip Morris Incorporated
Printing Industries of America
Procter & Gamble Manufacturing Company
Ralston Purina Company
RJR Nabisco, Inc.
Roadway Services, Inc.
Sara Lee Corporation
Sun Company, Inc.
United Technologies Corporation
UST Inc.
Wine & Spirits Wholesalers of America
Winn-Dixie Stores Incorporated
Yellow Freight System, Inc. of Delaware

TAX REFORM ACTION COALITION (TRAC)

GENERAL MEMBERSHIP

Air Conditioning & Refrigeration Wholesalers
Air Delivery Service Incorporated
Air Transport Association
Air Van North American
Allentown-Lehigh (Pennsylvania) County Chamber of Commerce
Aluer & Sons Shoes Incorporated
American Association of Advertising Agencies
American Electronics Association
American Express Company
American Federation of Small Business
American Foundrymen's Society
American Furniture Manufacturers Association
American Institute of Merchant Shipping
American Machine Tool Distributors Association
American Meat Institute
American Movers Conference
American Nurses Association
American Paper Machinery Association
American Pipe Fittings Association
American Supply Association
American Textile Manufacturers Institute
American Traffic Safety Services Association
American Veterinary Distributors Association
American Wholesale Marketers Association
Appliance Parts Distributors Association
Ardmore (Oklahoma) Chamber of Commerce
Arkansas Freightways
Armstrong World Industries, Inc.
Associated Equipment Distributors
Association for Suppliers of Printing and Publishing Technologies
Association of American Railroads
Association of Floral Importers of Florida
Association of Steel Distributors
Automotive Parts Rebuilders Association
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association
B. F. Fields Moving & Storage
Batesville Area (Indiana) Chamber of Commerce
Bearing Specialists Association
Beatrice Companies Inc.
Beauty & Barber Supply Institute
Bechtel Group, Inc.
Bicycle Wholesale Distributors Association
Biscuit & Cracker Distributors Association
Campbell Soup Company
Can Manufacturers Institute
Carlton Trucking Company Incorporated
Carolina Freight Corporation
Ceramic Tile Distributors Association
Chilton Corporation
CIC Plan
The Clorox Company
Columbia Motor Express Incorporated
Computer Dealers & Lessors Association
Consolidated Papers Incorporated
Contractual Carriers Incorporated
Coors Brewing Company
Copper and Brass Servicenter Association
Coshocton (Ohio) Area Chamber of Commerce
Council for Periodical Distributors Association
Craig Transportation Company
Criber Truck Leasing Incorporated
Crouse Cartage Company
Crowley Maritime Corporation
Cyclops Corporation
D. L. Merchant Transport Incorporated
Dart Trucking Company Incorporated
De Fazio Express Incorporated
Dobson Mover
Eddie Bauer Incorporated
Edison Electric Institute
Edmac Trucking Company Incorporated
Electrical Apparatus Service Association
Electrical-Electronics Materials Distributors Association
Elmer Buchta Trucking Incorporated
Engine Service Association
Equifax, Inc.
Fairmont Area (Minnesota) Chamber of Commerce
Farm Equipment Wholesalers Association
Federal Express Corporation
Federated Department Stores Incorporated
Federation of American Health Systems
Fluid Power Distributors Association
FMC Corporation
Food Industries Suppliers Association
Foodservice Equipment Distributors Association
Fort Howard Corporation
Friedl Fuel & Cartage Incorporated
GenCorp
General Delivery Incorporated
General Merchandise Distributors Council
General Mills Incorporated
General Nutrition Incorporated
Grass Valley and Nevada County (California) Chamber of Commerce
Greater East Dallas (Texas) Chamber of Commerce
Greater Rochester (New York) Metro Chamber of Commerce
Greater San Diego (California) Chamber of Commerce
Greater Seattle (Washington) Chamber of Commerce
Greater Syracuse (New York) Chamber of Commerce
Greenfield Transport Incorporated
Griffin Distributing
Hardwood Plywood Manufacturers Association
Hartford Dispatch & Warehouse Company Incorporated
Health Industry Distributors Association
Hewlett-Packard Company
Hobby Industry Association of America

Hospital Corporation of America
Household Goods Forwarders Association of America
Independent Medical Distributors Association
Independent Sealing Distributors
Independent Xray Dealers Association
Industrial Distribution Association
Institute of Industrial Launderers
Insulation Contractor Association of America
International Association of Plastics Distributors
International Communications Industries Association
International Hand Protection Association
International Hardware Distributors Association
International Sanitary Supply Association
International Snowmobile Industry Association
International Truck Parts Association
International Wholesale Furniture Association
Irrigation Association
Kelly Services Inc.
Kemp Furniture Industries Incorporated
Kent (Washington) Chamber of Commerce
King Transfer Incorporated
King Van & Storage Incorporated
Krenn Truck Lines Incorporated
Lacy's Express Incorporated
Land Trucking Company Incorporated
Larmore Incorporated
Locute Corporation
Machinery Dealers National Association
Manitowoc-Two Rivers Area (Wisconsin) Chamber of Commerce
Material Handling Equipment Distributors Association
Materials Research Corporation
Matterson Associates Incorporated
The Maxwell Company
McCourt Cable Systems
McLauren Trucking Co.
McRae's Incorporated
Metro Milwaukee (Wisconsin) Association of Commerce
Metropolitan Life
Mid-West Truckers Association
Minnesota Trucking Association
Mississippi Chemical Corporation
Monroeville Area (Pennsylvania) Chamber of Commerce
Montana Power Company
Moore & Son Trucking
Motorcycle Industry Council
Music Distributors Association
National Aggregates Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Brick Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Flour Distributors
National Association of Hose and Accessories Distributors
National Association of Meat Purveyors
National Association of Recording Merchandisers
National Association of the Remodeling Industry
National Association of Retail Druggists
National Association of Service Merchandising
National Association of Sign Supply Distributors
National Association of Solar Contractors
National Association of Sporting Goods Wholesalers
National Association of Truck Stop Operators
National Association of Water Companies
National Association of Wholesale Independent Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Commercial Refrigeration Sales Association
National Electrical Manufacturers Association
National Electronic Distributors Associaton
National Fastener Distributors Association
National Food Brokers Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Independent Poultry and Food Distributors Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Medical Enterprises
National Moving & Storage
National Paint Distributors
National Paper Trade Association
National Private Truck Council
National Ready Mixed Concerete Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Screw Machine Products Association
National Solid Wastes Management Association
National Spa & Pool Institute
National Tire Dealers & Retreaders Association
National Tooling & Machining Association
National Truck Equipment Association
National Utility Contractors Association
National Venture Capital Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
NCR Corporation
New Berlin (Wisconsin) Chamber of Commerce
Newark (Ohio) Area Chamber of Commerce
North American Heating & Airconditioning Wholesalers
North American Horticulture Supply Association
North American Wholesale Lumber Association
Odisco Transportation
Optical Laboratories Association
Opticians Association of America
Oracle Corporation-Government Affairs

Outdoor Power Equipment Distributors Association
PACCAR Incorporated
Pennsylvania House
Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America
Plattsburgh & Clinton County (New York) Chamber of Commerce
Power Transmission Distributors Association
Precision Metalforming Association
Priority Freight System Incorporated
Produce Marketing Association, Inc
The Quaker Oats Company
Red Lobster Inns of America
Red Star Truck Lines
Safety Equipment Distributors Association
Safeway Stores Incorporated
Salt Institute
Servicestation and Automotive Repair Association
Shared Medical Systems
Shoe Service Institute of America
Slidell (Louisiana) Chamber of Commerce
Small Business of America Inc
South Hills Movers Incorporated
Specialty Equipment Market Association
Specialty Tools and Fasteners Distributors Association
Square D Company
St. Lucie County (Florida) Economic Development Council
Steel Service Center Institute
Suspension Specialists Association
The Talbots Incorporated
Tarzana (California) Chamber of Commerce
Telecommunications Industry Association
Textile Care Allied Trades Association
Tomahawk Services Incorporated
Unifi Incorporated
United Fresh Fruit & Vegetable Association
United Products Formulators & Distributors Association
Valmont Industries, Inc.
W. H. Fitzgerald Incorporated
Walgreen Company
Wallack Freight Lines Incorporated
Wallcoverings Association
Ward Transport Incorporated
Ward Trucking Incorporated
Warehouse Distributors Association for Leisure and Mobile Products
Warren Trucking Company
Washington Water Power Company
Water & Sewer Distributors Association
Water Systems Council
Waukegan/Lake County Chamber of Commerce
Western Suppliers Association
Wheeler Transport Service
Whirlpool Corporation
White Sulphur Springs Chamber of Commerce
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers Association
William E. Stowe & Associates
The Williams Companies, Inc
Winfield (Illinois) Chamber of Commerce
Woodworking Machinery Distributors Association
Woodworking Machinery Importers Association
Zayre Corporation

APPENDIX B

TOP INDIVIDUAL AND CORPORATE TAX RATES

YEAR	INDIVIDUAL	CORPORATE	SPREAD
1991-1992	31	34	3
1988-1990	28	34	6
1987	38.5	40	1.5
1982-1986	50	46	4
1981	69.125	46	23.125
1979-1980	70	46	24
1971-1978	70	48	22
1970	71.75	49.2	22.55
1969	77	52.8	24.20
1968	75.25	52.8	22.45
1965-1967	70	48	22
1964	77	50	27
1954-1963	91	52	39
1952-1953	92	52	40
1951	91	50.75	40.25
1950	91	42	49
1948-1949	82.13	38	44.13
1946-1947	86.45	38	48.45
1944-1945	94	40	54
1942-1943	88	40	48
1941	81	31	50
1940	81.1	24	57.1
1938-1939	79	19	60
1936-1937	79	15	64
1932-1935	63	13.75	49.25
1930-1931	25	12	13
1929	24	11	13
1928	26	12	14
1926-1927	26	13.5	12.5
1925	26	13	13
1924	46	12.5	33.5
1922-1923	56	12.5	43.5
1919-1921	73	10	63
1918	77	12	65
1917	67	6	61
1916	15	2	13
1913-1915	7	1	6
1909-1912	No Income Tax	1	1

Source: Overview of the Federal Tax System, Committee on Ways and Means, April 10, 1991

Chairman ROSTENKOWSKI. Thank you, gentlemen.

Mr. Sydnor and Mr. Sullivan, you urged us to scrap the proposed temporary ITC in exchange for keeping the top corporate rate at the same rate. Since the revenue loss associated with the temporary ITC would not offset the revenue gain from the corporate rate increase, would you advocate a partial increase of the corporate rate, or do you have any other suggestions for making up the difference?

Mr. SYDNOR. Mr. Chairman, would you be kind enough to repeat that?

Chairman ROSTENKOWSKI. Since the elimination of the ITC doesn't raise enough money to retain the corporate rate at the same level of 34 percent, do you have any other suggestions as to where we could find revenues, if we eliminate the ITC?

Mr. SYDNOR. Sir, the business tax increases bring in, according to my information, $3 in revenue for every $1 in business tax breaks like the temporary ITC. Very simply, you know, as far as leaving the corporate rates where they are and the elimination of the ITC, basically we are using the same ratio as the President. He proposed $3 of increased taxes on business for each $1 of business incentives, and scrapping the incremental ITC and leaving the corporate rates where they are is basically the same ratio.

Chairman ROSTENKOWSKI. I am told, gentlemen, that the temporary ITC loses about $12 billion. The proposed increase in corporate rates raises about $30 billion. Now, we have got some money that we have got to find here. You know, I am just asking whether you have any ideas about this. I am not too enthusiastic, as you can recognize, about increasing the corporate rates, either.

Mr. SULLIVAN. Mr. Chairman, we are really using pretty much the same rates that the administration had used in their proposals, that the $30 billion that you get from the increased rates. My numbers I thought on the temporary ITC was like $9.2 billion, so you have $30 billion in increased revenue and you are giving back a $9.2 or $12 billion in your numbers incentive. Using those same ratios, if you are going to take out the revenue, the $3 to $1, if you are going to take out $1 of incentive, you then ought to take out $3 of revenue.

I admit that it is a little trickier arithmetic, but that is the same tricky arithmetic that has been put on the table to start with. If you back out $3 to $1, we ought to stick with that ratio.

Chairman ROSTENKOWSKI. Mr. Archer.

Mr. ARCHER. Mr. Chairman, I did not vote for this budget resolution, so I don't feel obligated to implement whatever instructions are sent to this committee, particularly because, as I mentioned preliminarily, it restricts us tremendously in this committee's jurisdiction to not be able to use spending cuts instead of tax increases. I personally do not believe that is what the American people are looking for. They certainly want the big spending cuts first, in any event.

But the chairman is constricted by whatever instructions are sent to him from the Budget Committee. That was a point that he was trying to make with you about how he is going to have to try to find that money somewhere, so that is going to be a problem with the committee.

I appreciate your testimony, because, as I looked at the 1986 tax reform process, the only real benefit from that entire exercise was reducing rates. Here we are talking about jumping the rates back up again, and that opens the door to demands for greater preferences. We are going right back up that same ladder again.

I am very grateful for this testimony that both of you have given, and I hope the committee listens to it. If you want to add anything to it with the little bit of time that I have left, I will be pleased to receive it.

Mr. SYDNOR. Mr. Archer, tax preferences are like drugs, sir. From 1986 to 1991, we had some withdrawal trauma, but we have learned to live with this and we have learned to play on the level playing field created by the 1986 act. If we reintroduce tax preferences, that takes away the underpinnings of the 1986 act and what it was founded upon, and this was low rates with few breaks. This was the cornerstone of the 1986 act.

While we support and commend the President's efforts to reduce the Federal deficit, it is very important to look at the specifics of how he proposes to reduce the deficit. We believe that the package is flawed fundamentally, because it relies far too heavily on tax increases.

I realize it is not the committee's function to decide the spending to tax ratio, but we urge you not to make matters worse on the tax side by walking away from the fundamental principle of tax reform—low rates on a broader base.

Mr. ARCHER. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Mr. Sullivan, assuming that you agree that the deficit is one of the major problems facing the Nation, and certainly this Congress, could you suggest a way to go about this other than the package that has been presented to us by the President?

Mr. SULLIVAN. Yes, Mr. Rangel. I think the basic premise is looking for jobs, looking for economic growth and deficit reduction, and I think it has somewhat been presented in that order.

I think the thrust of our testimony in the coalition that I appear on behalf of, and I need to stipulate that my franchise is limited to the TRAC's franchise, and that is rates, but we have found that the lowering of the rates and the economic stimulus that comes from businesses reinvesting as well as savings, individuals and corporations, as well, has been the best way to stimulate the economy.

Mr. RANGEL. Now, didn't we do this——

Mr. SULLIVAN. The move back from the 1986 act to start to pick winners and losers, to introduce complexities in——

Mr. RANGEL. I understand what you are saying and I agree with that. But when you talk about reduction of rates, didn't we dramatically do that in the Economic Recovery Act of 1981? I mean weren't the rates dramatically reduced, other sweeteners thrown in and the goal was to increase savings and capital formation and get America moving?

Mr. SULLIVAN. We did and coupled with—I think you have got to take the 1982 act along with the 1981 act, the TEFRA of 1984, but I think the 1986 act was the real foundation on which we made the structural changes and we have dramatically reduced the incentives, the hoops that you had to jump through to qualify. We

certainly moved away from tax motivated behavior, investment behavior——

Mr. RANGEL. I buy that part of your argument, but you don't see any reason for us to increase individual corporate rates and at the same time attempt to create jobs and reduce the deficit?

Mr. SULLIVAN. I think we need to create jobs, we need to stimulate the economy, and I think if you—what my point is, and I think TRAC's unifying glue that holds this together is that all of these businesses and individuals using their aftertax dollars will make the best market decisions in terms of——

Mr. RANGEL. Would you suggest the best way to decrease the deficit and create jobs is to further decrease the rates, the individual and corporate rates, to make them lower?

Mr. SULLIVAN. I would like to suggest that, and if I looked at the 1986 act in terms of the total revenue raised from—I have looked particularly at the corporate sector, you certainly raised more money. I think also if we look historically, that if we look at rate increases, it doesn't necessarily bring in more money in the aggregate.

Mr. RANGEL. So basically you are saying one of the tools we should think about to reduce the deficit is to reduce taxes?

Mr. SULLIVAN. No, I said I would like to do that, but given the——

Mr. RANGEL. We would like to reduce taxes, but what would you like to recommend to us?

Mr. SULLIVAN. I would like to recommend and I am recommending to the committee on behalf of the coalition that we not increase the corporate rates and that we be very, very careful as we look at the individual rates. And, in particular, if all that rate increase means is that you are going to turn around and take $3 and give back $1 of some kind of incentive, then leave the incentive out.

Mr. RANGEL. Forget the incentives. I am only talking rates.

Mr. SULLIVAN. Leave the incentive out.

Mr. RANGEL. Forget the incentives. So you are saying leave corporate rates alone and carefully structure increases in individual rates?

Mr. SULLIVAN. Personally, I would say leave the individual rates alone, too, but I understand——

Mr. RANGEL. Well, you are not here personally.

Mr. SULLIVAN. I understand there are many components of the package. Our message is that we want to make sure that aftertax dollars have just as much aggregate stimulation to the economy as funneling it through Washington, putting it through some particular screen or some particular program.

Mr. RANGEL. Thank you, Mr. Sullivan.

Mr. Hoagland.

Mr. HOAGLAND. Mr. Chairman, may I pass until the end of the questioning of these witnesses? I have a couple questions I would like to ask, but I am not quite ready yet.

Mr. RANGEL. OK. Mr. Hoagland passed.

Chairman ROSTENKOWSKI. Mr. Reynolds.

Mr. REYNOLDS. Thank you, Mr. Chairman.

I thank both of you gentlemen for coming today. Your testimony is interesting. I, too, am very interested in the various proposals

to change what the President has sent before us and what we are going to have to do. I did, in fact, vote for the President's package and I am someone who is going to be looking very hard at all proposals to change that package.

I had a question for Mr. Sydnor. In your testimony, you state that you have been compelled to instruct all of your managers to put a hold on proposed new spending. Later today, this committee will hear testimony from the National Association of Water Companies and others that are anticipating new spending and look forward to the enactment of this package. What is unique or specific to your industry that makes enactment of this package so detrimental to your industry?

Mr. SYDNOR. First, Mr. Reynolds, I believe I am a typical industrial distributor and, quite honestly, the reality is that small business distributors need retained earnings to grow their businesses. In my written statement, there is a letter that was written from a distributor in Baltimore to Congressman Cardin, and he makes the same point and demonstrates clearly that other businesses are also putting their investment spending plans on hold. Our fear is that the taxes in this package will stall the recovery, if not stifle it.

From a personal point of view as far as my own business is concerned, which I believe is typical, we increased overhead considerably in anticipation of an economic expansion during 1993, and if increased taxes stifle this expansion, not only do we have on hold right now any new positions which might have been created, but we are going to have to cut the positions that we added in 1992. Instead of job creation, you end up destroying jobs, and that means no new positions and cuts in current positions.

Mr. REYNOLDS. My question was, what is unique about your industry and about what you do that would make other companies say this is a good thing, but the uniqueness of what you do makes it a bad thing?

Mr. SYDNOR. What makes this particular act bad?

Mr. REYNOLDS. Yes.

Mr. SYDNOR. If you reduce the cash flow and the money that is available for reinvestment by new taxes and that reinvestment was going to be used to expand the business and to create new jobs, that is what is bad.

Mr. REYNOLDS. Let me move on. Do either of you have any cost estimates of repealing the proposed ITC in return for leaving the top corporate rate where it is today? If so, what are those estimates?

Mr. SULLIVAN. Would you repeat that, Mr. Reynolds?

Mr. REYNOLDS. Do either of you have any cost estimates of repealing the proposed ITC in return for leaving the top corporate rate where it is today? If so, what are your estimates?

Mr. SULLIVAN. The numbers that I had used was that it was $9.2 billion for the temporary ITC. The chairman has used a number of $12 billion.

Mr. SYDNOR. Sir, I am a businessman, quite honestly, and not a tax policy expert, and I have to rely upon my financial advisers in my business, as well as our trade association to give me this information and I do not have it right now.

Mr. REYNOLDS. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I thank both witnesses. Mr. Sydnor, I particularly want to comment that your association has been extremely helpful to us over the years in gaining a better understanding of the impact of both tax and health policy on the small business sector.

I was very interested to notice in your testimony that you mention that the average employment of the facilities in your association is 30 to 50 employees. I think that is important for this committee to understand, that you really are speaking from the point of view of the very people that we hope will hire and create new jobs and help us turn this recovery from a slow and rather jobless recovery to a job creating recovery.

While I oppose the President's package, I supported the concept of coupling additional tax revenues with far steeper cuts than were in the President's proposal, and I stand by that position. So I am looking for ways to support eliminating the corporate tax increase. I agree with you absolutely on the temporary ITC.

I would like you to look at two things. First of all, I would like you to get back to us on any business tax expenditures that are currently in the code that are not nearly as important as the corporate rate increase. I would mention that one of the constructive things in my mind that the tax proposal does is to reduce the benefit for business meals and travel and those kinds of incidental expenses. I think that subsidy needed to be reduced.

We do not allow you any more to deduct club dues. There is other stuff in the code that, frankly, those of us who do not apply it day in and day out, including yourself, are not aware of. But if you turn to your association to look at what are some of those rather little things, they do add up and that could help us in time.

Second, I would ask both of you to evaluate the impact of the new capital gains differential. What effect will that have on you? After all, the capital gains will be 28 percent, the highest individual rate will probably be 41.5 percent, some say 39.5 percent. At any rate, there will be a significant capital gains differential, if the President's package passes. How will that help to offset the corporate rate? What decisions will that drive? Where will that steer money? Your thoughts?

Mr. SULLIVAN. First, just the interaction of the two rates, Mrs. Johnson, and one of the things this committee always wrestles with is the double taxation of corporate dividends. The tilt that we are starting down the road here is that we are going to move away from investor tilt, ownership equity, and we are going to move back toward debt preference. Whatever the balance may be right now, the net tilt from the interaction of both the corporate rate and the individual rate will be in that direction.

If you take $1 of corporate earnings and you run it through the rates in 1986 and then you run it against the 28 percent individual rate, you would have 47.5 cents left in 1986 in that first phase. We then moved the individual rate up to 31, and you would have 45.5 cents left after that $1 of corporate earnings.

Under the President's proposal—I am doing top rates—the 36 percent, you would have 41 cents left after you ran it through the

36-cent corporate rate, and then if you did the top earners, you would have 38.5 cents left. So you can see what the tilt, moving from 47.5 cents to an investor return after tax to 38.5 cents, and you can see the dramatic tilt that we have already started from the 1986 act, and so there is going to be a definite tilt from investor to debt.

The capital gains differential will cause people to make decisions on moving income away from current income, trying to do everything they can to convert earnings into capital gains. There will be a new industry invigorated or an old industry reinvigorated, and that is called tax shelters. We will be back into tax motivated behavior, rather than true economic motivated behavior.

Mrs. JOHNSON. Thank you.

Mr. SYDNOR. Mrs. Johnson, could I make a comment?

Mrs. JOHNSON. Yes.

Mr. SYDNOR. Last night, not being able to sleep too well, I was perusing Forbes magazine and came across an advertisement which I brought with me this morning. It says "Tax Relief From Scudder." They are talking about the tax advantages of a new Scudder high-yield tax-free fund. The advertising has already started, suggesting that businessmen should move funds out of basic investment into tax-free shelters. This is exactly what we are talking about here today.

Mrs. JOHNSON. Thank you.

Chairman ROSTENKOWSKI. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

Mr. Sullivan, I can understand your concern about the tradeoff between the ITC and the corporate rate. If all things are perfect in the world and we could eliminate the corporate rate or do some changes that you people have mentioned this morning, would you want to eliminate the rate increase completely, or would you want to have some of the money go toward a more comprehensive fix with the alternate minimum tax? What I am trying to say is—I will say it—is your priority the rate or the alternate minimum tax?

Mr. SULLIVAN. My priority is the rates. It also happens to be the limitation in terms of my franchise of the coalition, the tremendous breadth of organizations and associations and businesses that are involved in TRAC from 1985, when we first started formation of TRAC and the formation of it in 1985. Every time we tried to get outside the rate box, we found ourselves coming back to rates, because that was the common glue which all of these businesses could agree on. So I am constrained really to say that rate is our linchpin.

Mrs. KENNELLY. Thank you, Mr. Sullivan.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Mr. Sydnor, I have a couple of questions. We are in the economic situation where we have a huge deficit and we are not having the growth out of the economy that we want, especially in terms of job growth in the economy, and so the President has come forward with a specific plan to fix that.

You know, we are going to have to make some difficult decisions here and I guess I would like an understanding, if you were us,

what would you do? And these are not always fun decisions to make.

On the one hand, we could take an approach to raise the overall corporate rate a couple of points or one point, or, on the other hand, we could nickel and dime our way through such things as increases on waterway usage taxes, we could reduce the deductibility of business lunches, we could change the treatment of royalties and raise some revenue, we could tax security transfers. We could do all those other things, or we could just simply flat across the board raise the corporate rate. If those are the two choices, which do you think is better tax policy?

Mr. SYDNOR. Sir, I believe that by raising the corporate rates you are going to decrease tax revenues. I think you are going to stifle the economy, I think you are going to stop the economic expansion in its tracks, as anemic as it may be. For a businessman, I can tell you that all of our customers are taking a wait-and-see-type attitude.

Mr. KOPETSKI. So you are saying we should go after these other user fees and transaction fees, that is the way this committee goes? Doing nothing is not an option. That is not an option. We have to do something, we have got the deficit, we are forced into this situation, and if you are doing on this side of the table, doing nothing is not an option for us. So can you help us out here a little bit?

Mr. SYDNOR. I realize that reduction in spending is not the charge of this committee, but from a business perspective, reductions in spending must take a high priority in Congress.

Mr. KOPETSKI. That is not an option. We are doing that over in some other committees and in that House we are doing that part as much as we can in the politics of this situation, but it comes back to raising some more revenue, and that is what the decision is we have to make.

Now, you can help us out by saying which of these two routes is better to go, the nickel and dime approach or just across the board raise the corporate rate.

Mr. SYDNOR. Sir, I am really not prepared to give you an alternative to your dilemma. I do, however, have to repeat that I believe that any increase in the tax rate will stifle the economy and that we are going to be in a worse position than you are right now. I think if we return to tax preferences, you will find the same consequences.

Mr. KOPETSKI. Well, let me just move to Mr. Sullivan quickly. A lot of us share your concern about S corporations and their treatment in the President's plan. We recognize the significance of those kinds of small businesses in our economy and there are those of us that are trying to see if we cannot massage that aspect of it, as well.

I would also like to hear your thoughts, though, on expanding the thoughts on the double tax of corporations through dividends. If we did not do the temporary ITC and if there was enough money there to start down the road of eliminating that double tax, do you think that is good tax policy and an appropriate use of those monies, if you will, or would it be better to reduce the overall corporate tax rate?

Mr. SULLIVAN. It definitely would be better to reduce the overall tax rate. One of the things that we have talked about in that double taxation, we start today from a snapshot where the corporate rate, the top rate is 34 and the individual rate is 31, so the corporate rate is 3 points higher.

For many people in the public, as well as some people in Congress, they think it has always been that way. It has only been since 1988 and 1987 that the corporate rate was higher than the individual rate, and that is how you got away from a little bit of the double taxation. The rate right now is a 3-point negative spread with the corporate higher. It was 6.

When we did the transition after the 1986, it was 1.5 points. The corporate rate was 40 and the maximum individual was 38. Pre-1986, that differential was 4 points, where the corporate rate was 4 points lower. So there has been an equilibrium between S's and subchapter C corporations and individual rates.

We have lived now for 6 years with the new equilibrium. The only time since 1909 that the corporate rate was higher than the individual rate has been from 1987 on. So as you deliberate this, I guess I would ask you not to use today as the fairness standard, and to also keep in mind the double taxation, the impact that has on investment decisions and the tilt it has between equity and debt.

Mr. KOPETSKI. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Grandy.

Mr. GRANDY. Thank you, Mr. Chairman.

Gentlemen, I guess I would just say, having listened to the questioning up to this point, it is certainly not incumbent upon either one of you or any of the panelists that follow you, to tell us what taxes you would raise, so we can fund greater spending. Just because we have put ourselves in a box that says we cannot go back in and reduce the outlays of the Federal Government to make up the shortfall that we are currently experiencing, that does not mean that you can't live by that.

I think it is unfortunate that we are all of the sudden confined by these rules that say if there is not some kind of government scorable savings, it doesn't exist. Don't play by our rules, for heaven's sake, because that way lies deficits and debts.

I said that because I am reminded, as we are having this hearing about how to layer sparkplugs into the economy at this point, that we were essentially doing the same thing last year at this time. I was out in my district last year talking about the then Bush administration's plans for passive loss limitation, capital gains reduction, what they were calling the investment tax allowance—pitching this.

I am sure, Mr. Sydnor, that some of the members of your association, serve in local government jobs while they were running their business. I remember trying to do this very elaborate sales job on why all of this stuff is really going to turn the economy around. Of course, we were going to pass all of the extenders and everything was going to be great.

I heard something from a guy who was a small businessman and also a mayor of a small town. He said to me I think something that

this committee ought to listen to, which is "why don't you people stop looking for the middle class and start listening to middle America." He said, "Don't you realize that the collected weight of the Clean Air Act, OSHA regulations, the Americans With Disabilities Act and the cumulative labor laws, plus the new complications that we have layered into the IRS Code have already taken away more than you could ever give back with some dopey little 7 percent investment tax credit?"

I think the same rules still apply, do they not? I mean wouldn't you argue that since 1986, one of the biggest costs of doing business in both of your associations is the accumulated regulatory burden that collective governments have imposed on your businesses?

Mr. SYDNOR. Sir, there is no question about it.

[Applause.]

Chairman ROSTENKOWSKI. The Chair would like to remind you, ladies and gentlemen, that you are our guests here and any demonstration is not tolerated.

Mr. Grandy.

Mr. GRANDY. I'm sorry, Mr. Sydnor.

Mr. SYDNOR. I would just point out that our company has 155 employees. If you told me several years ago that we would have to have employees that did nothing but file Government regulatory forms and do compliance manuals and properly file all of this, I would never have believed it. The regulatory burden has a tremendous expense attached to it for businesses.

Mr. GRANDY. Understand that under the purview of this committee, we are not allowed to talk about regulatory relief, because that is not in Ways and Means' jurisdiction. I am not going to try and bend those rules as if I had the power to do so.

But it is important to layer that into this discussion, because actually what we are doing on this committee is raising taxes to pay for more spending. And what you are arguing I think, unless I am very wrong, is don't spend it. And if you want economic growth, roll back some of the disincentives that are elsewhere in the panoply of Federal law-making that are keeping us from realizing businesses.

Now let me go to a specific tax question, because I think this is one of the things that we have to be mindful of. I have only been on the committee for a couple of years, but already in that amount of time we have made the code infinitely more complicated to pay for various sparkplugs in the economy.

But under the temporary incremental tax credit, which I guess is 7 percent, there is a provision that would recapture the credit, if the investment falls below the 3- to 5-year base period after the investment tax credit years. For instance, if in the 1989 to 1991 base period the investment was $100, and then during the 1993 to 1994 ITC years the investment is increased to $120, but falls in 1995 to 1996 to only $60, then that part of the credit received in the ITC years has to be given back to the Government in 1995.

Is there anybody in your association that would use that, knowing that there is a give-back provision, if you are not able to meet certain thresholds? Is that tax friendly law to you, sir? I mean is that a big boost to your bottom line?

Mr. SYDNOR. Sir, not only would I call that defeating the purpose, it is self-defeating. It is complicated to the point of absolute absurdity and it really has no benefit whatsoever.

Mr. GRANDY. There is kind of a consensus, particularly now that the reins of rule have changed hands, that doing nothing is not a strategy, it is an absence of a strategy. All I hear from the people that I represent, is for God's sake, leave us alone. It is not a sin of omission, it is a sin of commission.

I guess what I would argue is one of the kindest things that we could do is to keep the code as simple as we can. I campaigned in 1986 on the Tax Reform Act. I wasn't elected on it, but I can tell you that a lot of people out in rural Iowa were infuriated by the investment tax credit, because it was driving small farmers out of the livestock business, so dentists in Manhattan and Denver could get into it. And that is exactly the kind of thing we are going to start again, not intentionally, but, of course, the law of unintended consequences is the one law that we have successfully passed over all of the legislation that we have presided over.

So I guess what I am asking for here is a statement from both of you. If we did nothing, if we did not pass an investment tax credit or a capital gains or any kind of economic stimulus package, and left the rates alone, could you survive in these troubled times?

Mr. SYDNOR. Exactly, sir. I just want to repeat myself that we must not return to the pre-1986 days of a Tax Code filled with preferences. Preferences do nothing but breed shelters. They replace the marketplace as an economic decisionmaker, and we all know the tax preferences are just plain inefficient.

The goal of the legislation this committee is considering is economic recovery in the short term and sustained growth in the long term. We will not get sustained growth by taxing ourselves into job creation and prosperity. I just do not know of any nation in history that has ever done that.

Mr. GRANDY. But it is indeed an economic stimulus, if we let you alone and concentrate more on what Government has done to you, than what Government may do for you, right?

Mr. SYDNOR. Yes, sir. I said that 1986 to 1991 was traumatic. Everyone has learned to live with the level playing field, however, and everyone can now do well with the 1986 act in full effect. If you reintroduce preferences, however, it is back to the old game again.

Mr. GRANDY. Then let us worry about compliance with the 1990 Budget Act and you folks just keep making money.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jefferson.

Mr. JEFFERSON. Thank you, Mr. Chairman.

I have been perusing the testimony, Mr. Sullivan, having missed the oral presentation due to my attendance at a District of Columbia committee meeting, and I heard Mr. Kopetski's questions and the other members who had some brief discussion this morning.

I don't want to ask you what you would do in our places, but I do want to ask you for an explanation as to how the results that you talk about occurring in the event of the adoption of the President's plan, particularly raising taxes, will result in the dramatic effects that you talk about will occur in your testimony. You use

words like “a 5 percent increase in individual rates will have a devastating effect on business.” You talk about a similar effect by raising the corporate rate.

I would like to just try to get an understanding as to what the details are, how these effects would take place, what do you see actually happening. These are conclusory remarks here and I want to get some explanation as to what you really mean, what do you see happening in the marketplace if these taxes are imposed.

Mr. SULLIVAN. First as to the statement on the 5-point, I know the statement says 5 percent, but it is a 5-point increase in the individual rate, which translates to 16.1 percent, and that is just moving it from 31 to 36. That doesn't include the extra one that moves it up to 39.6.

People are going to have less money to spend and to invest. In terms of the corporate rate, it may have happened, Mr. Jefferson, before you came in, but we talked a little bit about the interplay between the individual rates and the corporate rates. There is going to be definitely a tilt away from equity investment in businesses that create jobs and stimulate the economy, and there is going to be more debt inducement for businesses that want to expand or start up.

I have contrasted the interchange between the individual top rates and the individual corporate rates under the 1986 act. If you had $1 of corporate earnings and then you took out the corporate tax of 34 cents and then you took out 18.5 cents of individual tax on that remaining 66, you had 47.5 cents.

As you move through the 1990, when we moved the rates up to 31 percent individual, and now the proposal to move the corporate rates up to 36 and the individual up to 36, you will now have 41 cents left—that interim was 45.5—and then for the top individuals, the 39.5 cents, you are going to have 38 cents left. So there is definitely going to be an influence on how people invest their money, what money is available for business, what money is available to create jobs.

So that is the basis upon which that statement was made. It is a philosophical one of whether you bring the money to Washington and decisions are made where to spend it and how efficient and what comes back. In the case of this temporary ITC, we see so much paperwork in terms of accountants, in terms of tax advice to qualify, we see a lot of Government money spent from IRS agents auditing and challenging.

The energy investment tax credit was a case where I witnessed a lot of supermarket operators do their best to qualify for the energy investment tax credit. They had to lay in separate electric lines to the cabinets, they had to make sure it was personal property that wasn't part of realty, they used engineers and everybody else to give them advice.

They did all of that because it was tax motivated and not necessarily economic motivated. There were picked winners and losers. Air-conditioning in a supermarket did not qualify for ITC, the equipment for that. It did in a factory. A parking lot out in front of a Schwegmans' store didn't qualify. A parking lot in front of a factory did. So pre-1986, you had these winners and losers.

We went through lowering rates and there was dramatic income to the Government from those lower rates, because there was more economic activity, there was less paperwork activity in terms of trying to move something out of earnings and get it into capital gains or get it into some category to qualify.

Chairman ROSTENKOWSKI. The Chair is noting that some of the points that are being made are being repeated, and the Chair would just like to caution the membership that we have a long day today, we have seven panels to go through. I am just hoping that the membership will attend the meetings and hear the answers to the very questions that have been answered earlier in the day, so that we could proceed in a manner which gathers information and yet expedites this hearing.

Mr. Sullivan, your time is up. Mr. Jefferson, your time is up.

Mr. Matsui will inquire.

Mr. MATSUI. I have no questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Coyne will inquire.

Mr. COYNE. No questions.

Chairman ROSTENKOWSKI. Mr. Santorum will inquire.

Mr. SANTORUM. I am going to pass. [Laughter.]

Chairman ROSTENKOWSKI. Mr. Houghton.

Mr. HOUGHTON. Sorry, I do have a question.

I would like to ask Mr. Sydnor, in your testimony you have talked about the numbers on an industry. You talked about NAW support for tax reform and you have talked about the fact that the environment is far different today than it was in 1986 and that there is a deficit hanging over our heads.

You talked about the fact that there will be a problem with the spread between the income and the capital gains, there will be an increase in tax dollars, there will be a reinstatement of the preferences—all that sort of good stuff.

But you really haven't talked about, other than one statement, what specifically the President's program is going to do to affect your business. And you said what you have done is put a hold on all capital spending now.

Now, I used to be on your side of the aisle, so I understand what you are going through. However, you are not telling me, are you, that you are never going to spend another dollar on your business, irrespective of what happens with the President's program? And you are not telling me that you are never going to hire anybody else.

You see, the important thing for this committee I think is to understand the impact specifically on businesses like yours, which are barometers for all of us. The whole point is not just the deficit reduction or a tax program, it is to have this economy move along and create more jobs. Maybe you could be more specific.

Mr. SYDNOR. Sir, last year we saw the economy pick up in the industrial distribution business in March. Normally we are a bellwether, because we sell to the manufacturing sector. When our business picks up markedly, generally speaking, "the man in the street" will feel that economic surge 6 months later.

Unfortunately, for whatever reason, business tailed off in about May or June and then crept along until the end of the year incrementally to where you probably saw a 2- or maybe a 4-percent in-

crease in overall activity. Based on the sputtering and the hold-back, it was generally felt that, regardless of who won the national election, that you would see a significant economic expansion in 1993 and you couldn't really hold off on investments any longer.

Now, we get into 1993, after having made plans for significant increases in our overhead and in our spending, but the economic expansion has not occurred. We still see the economy moving in the manufacturing sector in fits and jerks, where business is good one week, horrible the next. For 3 weeks, it's good, the next month it is so-so.

You do not have a recovery that is sustained out there. Because of the lack of economic activity and growth, our greatest fear is that any increase in the corporate tax rate is only going to add to the problem and stifle, if not smother, the economy. Certainly, under this current scenario, we are not going to pursue any new spending increases now until we can see exactly which way the economy is going to go.

Mr. HOUGHTON. Very quickly, if the economy picked up, business was better, irrespective of what this tax increase did to you, you would invest and employ more people, because of the level of the economy.

Mr. SYDNOR. If the net to us was the same or greater. But if you increase taxes, the net will not be the same, so there will be less money for reinvestment.

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. I have no questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Hoagland.

Mr. HOAGLAND. Mr. Chairman, I just have one question of each of these individuals.

Gentlemen, you have both criticized the temporary investment tax credit, but it has always been in relation to how the funds might otherwise be used. Assuming that it costs about $12 billion—the temporary one, not the permanent one for small business; those are the figures that we have from the Joint Tax Committee—or assuming your figures, Mr. Sullivan—I think your figure is $9.2 billion or something in that range. My question of you is: Strictly independent of how the money might otherwise be used, whether it is applied to the deficit, to the corporate tax rate, whatever purpose it might be put to, is it your opinion that we should abandon it because it is not worth the money it is going to cost?

Mr. SYDNOR. Sir, we still get back to the basic underpinnings of the 1986 act. You are creating preferences again, taking away the level playing field. And, specifically, the long-term use of the investment tax credit is marginal at best.

Mr. HOAGLAND. Mr. Sullivan.

Mr. SULLIVAN. I think you set up a condition that brings out behavior that isn't in the best interest of the economy or for individual firms. You start with the premise that we are going to increase the rates, and then they say: "Would you like to have some crumbs back? We will let you go through these particular mazes, and you can get some things back." And if you then remove it and say, "Well, wait, the rate stays but we don't give you the crumbs," then I think everybody has got to say: "Listen, we want to get back anything we can get back." But the premise is sort of faulty to set up

that inefficient—it isn't going to do an awful lot for businesses except create some jobs in accounting, and it is going to create a lot of tax revenue agent jobs.

Mr. HOAGLAND. So it sounds like you both feel that, regardless of what the funds might be used for, we shouldn't spend the money on this. Is that fair?

Mr. SYDNOR. That is fair.

Mr. SULLIVAN. I don't want to say that because I think that we want to get back what we can get back. We want to salvage it. And so if the new rules of the game are let's play irrational, let's play inefficient, then we will need to play in—whatever the field is that is laid out, we are going to need to play in it.

Mr. HOAGLAND. But you think it is irrational and inefficient?

Mr. SULLIVAN. It is inefficient.

Mr. HOAGLAND. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Hancock.

Mr. HANCOCK. I have got just a couple of questions. Both of your testimony and the discussion pertains to the impact on subchapter S corporations. I happen to have a subchapter S corporation in the private world. We have been talking corporate tax rate all the way through.

Would there be an incentive on subchapter S and partnerships for the money that people that own subchapter S can't get out of their companies? In other words, where they have to continue to reinvest the profits. For those profits that are left in the company, to apply the corporate tax rate rather than the individual tax rate until such time as they are pulled out of the company?

Mr. SYDNOR. Are you saying that the money is pulled out of the company rather than left in the company?

Mr. HANCOCK. What I am saying is: For example, a subchapter S company, at the end of the year has a profit of $200,000. All the owner can take out of his company is $100,000, perhaps because of the inflation of his inventory. In other words, all he can take out to take home is $100,000. He leaves $100,000 in his company. What would happen if you taxed that $100,000 left in the company at the corporate rate rather than the individual rate? Wouldn't that create an incentive on the subchapter S and the small business people to leave money in their companies and expand them if, in fact, they knew that money was not going to be taxed at the full individual rate until they took it out of the company?

Mr. SYDNOR. Generally, sir, I believe that in subchapter S corporations, the money is left in the company. That money is needed——

Mr. HANCOCK. But it is taxed——

Mr. SYDNOR [continuing]. To expand. It is taxed at the personal rate.

Mr. HANCOCK [continuing]. At the personal rate. Is that fair?

Mr. SYDNOR. In a subchapter S, the only source of capital in most cases is retained earnings. If you increase the tax rate on those subchapter S corporations or sole proprietorships which pay taxes at the individual rate level, you are going to take away the money that is needed for reinvestment in that business.

Mr. HANCOCK. That is the point that I am trying to make. But would it make sense for that money that is retained, the invest-

ment that he leaves in his company, to tax it at the corporate rate until such time as he takes it out, maybe 5 years later? Then he would pay the higher individual tax rates under the present way we are set up.

Mr. SYDNOR. Sir, I really can't answer that question.

Mr. HANCOCK. I thought it was a fairly straightforward question. If I can leave money in my company at 31 percent—I mean, if there is an incentive for me to leave that money in there—then there is an incentive to expand the company. In fact, you can't expand the company if you are going to take 40 or 45 percent of the money out and send it into the Government, which is what is going to happen under the President's proposal in the subchapter S companies.

Mr. SYDNOR. Are you recommending that you do away with the subchapter S corporations and have them all go to C corporations?

Mr. HANCOCK. No, I am not. No. What I am recommending is to give the small businessman a break. Why should he pay 40 percent tax on his profits when he can't get his money out of his company. He could go C corporation.

I am saying the tax law should be an incentive for him to leave money in the company and expand his company.

Mr. SYDNOR. Right.

Mr. HANCOCK. OK. We will talk about it later. Thank you.

Chairman ROSTENKOWSKI. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

I am not going to ask any questions. I just want to make a point. I thank the speakers for their knowledge and their expertise.

I know that you know that we have a frustration here in the system. When the budget resolution has been passed, we have to find the revenue. But I would say to my friend from Oregon—who is not here, I don't believe—that we do have one other option. I don't mean this as a partisan statement, but as a statement from someone who is frustrated with the way things are going. We could vote down the budget resolution this week and go back and have a new budget resolution that had less spending. We wouldn't have to inflict the taxes that we are being forced to do on corporations and change the investment tax credit and make the changes that you all have recommended.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Sullivan, Mr. Sydnor, thank you very much for joining us. It has been a pleasure, and you are dismissed.

Mr. SYDNOR. Thank you, Mr. Chairman.

Mr. SULLIVAN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Hartley-Leonard, Mr. Berman, Mr. Leffler, Mr. Wachtel, and Mr. Juliano.

Welcome, gentlemen, to the committee. I think some of you, maybe even all of you, have testified here before.

You know our rules. We would like you to make a brief statement. If your written statement is longer than 5 minutes, we would like to include that in the record and have you summarize. However, we would like very much for you to stay within the limitations. As I am sure you heard me explain, we do have a long day here. We are looking forward to your testimony.

Mr. Leonard, welcome. I hope the weather is pleasant in Chicago.

Mr. HARTLEY-LEONARD. It was raining this morning, Mr. Chairman.

Chairman ROSTENKOWSKI. Welcome to a sunny climate here.

Mr. HARTLEY-LEONARD. Thank you.

Chairman ROSTENKOWSKI. If you would like to begin, Mr. Leonard? What I would like for you members to do is to identify yourself for the record and then proceed into your statement.

Thank you.

Mr. Leonard.

STATEMENT OF DARRYL HARTLEY-LEONARD, PRESIDENT, HYATT HOTELS CORP., CHICAGO, IL, CHAIRMAN, U.S. TRAVEL AND TOURISM ADVISORY BOARD, AND CHAIRMAN, TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL, ON BEHALF OF AMERICAN HOTEL & MOTEL ASSOCIATION

Mr. HARTLEY-LEONARD. Mr. Chairman, members of the committee, thank you for this opportunity to testify today. I am Darryl Hartley-Leonard, and I am the president of Hyatt Hotels Corp., which operates 106 hotels and resorts in the United States, Canada, and the Caribbean, and we have some 46,000 employees.

This year I also serve as chairman of the U.S. Travel and Tourism Advisory Board, which is a board legislated by Congress to advise the U.S. Secretary of Commerce on tourism issues; and I also serve as chairman of the Travel and Tourism Government Affairs Council, which is a private sector group representing the industry's viewpoint on legislative and regulatory issues.

I am here today representing the interests of lodging as represented by the American Hotel & Motel Association. The lodging industry employs approximately 1.5 million people, with close to one-third of them involved in food service.

The hotel industry, as you may or may not know, has been suffering from a downturn of epidemic proportions for the last several years. In 1990 alone, losses for the U.S. hotel industry were estimated at $5.5 billion. For 1991, the losses were estimated at $2.7 billion. Ours is an industry in deep trouble which has had to take strong steps to stabilize its position.

As other businesses economize, we suffer. An article in the Wall Street Journal of December 16 this past year discussed the subject of business travel and made some unsettling observations. Corporate travel budgets have been reduced. Corporations are adopting new ways of communicating. Corporations are saying they simply will not travel as much in the future.

Now, that may lead you to believe that we are here to look for a hand-out. Well, we are not. We are not even looking for a hand-up. What we are looking for is hands-off.

In 1986, when the deductibility of business meals and entertainment was reduced from 100 percent to 80 percent, we strongly opposed that reduction, predicting revenue and job loss. Congress' assumption that our industry could take the hit and that there would be no impact was a false assumption.

A recent unpublished study showed that the overall food service sales have permanently dropped some 3.4 percent as a result. For 1991, one could calculate that at $6.5 billion.

There were several positive factors that helped mask the negative impact. One such positive factor was the inclusion of the banquet exception. This was a 2-year transition rule keeping deductibility at 100 percent on certain large meal functions. It recognized the fact that these events were frequently scheduled long in advance of the actual date, in reliance on existing tax laws.

We believe this exception also was a recognition of the unique non-personal consumption that takes place at large group functions. It was an appropriate exception, and it did help delay jobs and revenue loss for some years.

Another positive factor was that the late 1980's were boom years for the lodging industry. Today, as we all know, that environment has radically changed.

Even with those positive factors, it has been estimated that as a result of the 1986 act, job losses in the lodging industry reached as high as 25,000.

Now, we admit that that is history, and we don't expect you to undo that now. But neither do we expect you to deny the reality of the loss in the past and the reality that a similar or greater loss will occur in the future.

Now, we need to consider the President's economic plan. I was astounded to hear what recently was said in this very committee room in response to a question by one of the distinguished members of this panel to the Secretary of Treasury concerning the impact of the proposal on convention business. Secretary Bentsen said there would be no impact on our industry, no reaction on the part of the business community, and no change in consumption patterns as a result of a reduction by more than one-third in the deductibility of a legitimate business expense.

Be assured, ladies and gentlemen, he is dead wrong. And we find some solace in the fact that the gentleman posing the question did not find the Secretary's answer credible. That belief should be rejected by this committee once and for all. What really matters is how many working Americans you will displace from their jobs this time.

First, I want to note that the impact will be felt most severely in the full service segment of our industry and will be concentrated in those hotels catering to business travelers, typified by large convention hotels found in and around all major U.S. cities. These hotels provide a broad range of jobs—jobs that some elitists disparage, but jobs that provide entry into the job market for young people, women and minorities, and those without higher education, those who pay mortgages, send their kids to college, and lead fulfilling and important lives.

We are proud of the jobs our industry creates. Our employees are not faceless numbers to be totaled up and discarded by Congress or the administration.

How many will we sacrifice this time? You will hear from the National Restaurant Association that there would be 165,000 food service jobs lost. We believe this is a conservative estimate. Lodging's share of the job loss, as estimated by various industry experts, is expected to be in the range of 15 to 25 percent of the NRA total, or 25,000 to 40,000. When you realize that includes part-time, seasonal, and temporary employees, the number actually dislocated

will likely be at or way above the 40,000-person level. That is almost as much as my company—Hyatt's—total employment. It is like completely wiping out my company.

In fact, at Hyatt we believe the proposed reduction will have a dramatic impact. We conservatively predict a loss of some $50 to $75 million of the $350 million in annual catering sales. And we estimate that we will have to fully or partially close about 40 percent of our 200 restaurants, which to date have only been, at best, break-even propositions. I am afraid it may cost Hyatt 4,000 to 5,000 jobs, and I am only hoping that it will be that low.

The overall food service job loss will not be spread evenly across the country. The bulk of the lodging jobs will be lost primarily at large convention hotels in urban areas. It is city jobs in cities like Chicago, Washington, Atlanta, New York, New Orleans, Los Angeles, San Francisco, Detroit, Boston, Houston, Milwaukee, Baltimore, Louisville, Tampa, Pittsburgh, that depend sizably on convention revenues for their financial well-being. As Mr. Reynolds only knows too well, those are the jobs that will be lost.

Many who lose their jobs may not have the ability to seek jobs in other industries. It will fall to the cities and the States to provide them support through unemployment, Medicaid, and welfare.

This will happen because business will react in a number of ways. The individual business traveler will trim the number of trips taken and the level of expenses for those trips still taken. At conventions, the number of attendees will shrink, and the level of expenditures by event sponsors will decline. Even our remaining employees will be affected as they lose service charges and tips.

In summary, American business does react. The city of New York relearned that lesson recently when its hotel occupancy tax of 21.25 percent was estimated by the city comptroller and former Congresswoman Elizabeth Holtzman to have caused the city to lose $1.1 billion over the last 5 years. Now Governor Cuomo is considering repeal of part of that tax.

In fact, I spoke to Jonathan Tisch of Loew's Hotels yesterday. He told me that, the day before, Governor Cuomo announced he is making a rollback of the 5 percent one of his No. 1 priorities.

Congress itself is grappling with the reaction to one of its own laws on so-called luxury items. Congress thought it could simply tax luxury items and reap the benefits. Instead, purchasers reacted and devastated an industry. Who lost? The workers building those boats, they lost because they lost their jobs.

Now Congress is being led to believe it can simply tax business by reducing the deductibility of business meals and entertainment and reap the benefits of increased revenue. It didn't work with luxury boats. It won't work with business meals and entertainment. An 80 to 50 drop will cause a steep reduction in food service employees, and others will lose their jobs as businesses refuse to accept added expense.

We urge this committee to retain the deductibility of business meals and entertainment at its current level. The administration has committed itself to creating jobs through a stimulus package. We find it inconceivable that the administration would undercut as much as 40 percent of its effort in that area by destroying what could be at least 165,000 food service jobs and exacerbating unem-

ployment in major cities. The effects of your actions will be permanent. A further eduction in the deductibility of business meals and entertainment should not be made.

This, Mr. Chairman, is an industry already in crisis. Full-service hotels are already having to close restaurants. As you noted to me this morning, Mr. Chairman, by the closing of, as you said to me, "one of my favorite restaurants at the Hyatt Hotel here on Capitol Hill," that closing put approximately 40 people out of work last month, 1 mile from this building.

One can assume that with further reduction in the deductibility of business meals and entertainment, as the saying goes, "You ain't seen nothing yet."

Thank you.

[The prepared statement follows:]

STATEMENT OF AMERICAN HOTEL & MOTEL ASSOCIATION, BY DARRYL HARTLEY-LEONARD, PRESIDENT, HYATT HOTELS CORP., CHAIRMAN, U.S. TRAVEL AND TOURISM ADVISORY BOARD, AND CHAIRMAN, TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL

INTRODUCTION

The American Hotel & Motel Association is a federation of associations representing lodging's interests in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands. The Association federation has a membership in excess of 10,000 individual lodging properties which represents approximately 1,300,000 rooms. Inclusive in our membership are all of the major hotel and motel chains and a large percentage of independent properties. The lodging industry employs approximately 1,500,000 people, with close to one-third of that total involved in foodservice.

The hotel industry has been suffering from a downturn of epidemic proportions for the last several years. In 1990 alone, losses for the U.S. hotel industry were estimated to be $5.5 billion. For 1991, the losses were estimated at $2.7 billion. However, when you research into the components of the industry, you learn that, in 1990, limited-service hotels (those without foodservice) only posted a small loss and, in 1991, recorded a positive net income. What this tells us is that the burden of our industry's losses in 1990 and 1991 were borne by full-service hotels, i.e., those with restaurants, room service, catering departments and which host our nation's conventions, trade shows, business meetings and banquets.

Other evidence exists to show the dire condition our industry has been in for the 90's. Our occupancy rate was at a 20-year low in 1991. As an aside, in 1985, when this Association testified before this Committee on the original proposal to restrict the deductibility of business meals and entertainment, we noted that our occupancy rate in 1985 was 67%. Now for the last several years, the occupancy rate has been hovering around 60%, a 10% decline in business and a direct cause of the billions in losses referred to above.

As a direct result of industry losses, across-the-board reductions in our labor force have been made, cutting, for example, in 1991 alone, over $1 billion in payroll and related costs.

The overall picture one is left with is of an industry in deep trouble which has had to take strong steps to stabilize its position. The fat is gone; now this Committee could be putting the muscle in danger. With losses for 1991 less that half of 1990 losses, there is a sense that we may have turned the corner and be on a gradual course taking the full-service segment of the industry back to a break-even point and eventual profitability. But changes in business consumer patterns may well work against our industry's recovery.

While our industry has suffered mightily over the last few years, we recognize that we aren't the only industry so afflicted. However, as other businesses economize, we suffer as a result. An article in the Wall Street Journal of December 16, 1992, discussed the subject of business travel and made some unsettling observations. First and, perhaps, most obvious is that corporate travel budgets have been reduced. In recessionary times that is to be expected, but a complicating factor is the massive number of white collar jobs that have been eliminated. That reduces the pool of business travelers. At the same time, corporations are adopting new communications technology, such as video conferencing, E-mail and the ubiquitous fax, to reduce even further the need for business travel as business recovers from the current recession. Corporations are saying they simply will not travel as much in the future. The Wall Street Journal article cites research sources indicating that business hotel room bookings were off for the third consecutive year and that there was a trend away from full-service hotels to limited-service, a trend verified by the loss statistics cited above.

Despite the troubles and changes in business practices outlined above, the lodging industry sees a challenge in the future of responding to the changing needs of corporate America. Despite what you may be expecting at this point, we are not here looking for a handout and we are not even looking for a hand-up. We are looking for hands-off though.

BACKGROUND: THE TAX REFORM ACT OF 1986

In 1986, the deductibility of business meals and entertainment was reduced from 100% deductible to 80% deductible. This was an unprecedented action by the federal government. It was conceded that these expenses were "ordinary and necessary" as required by the Internal Revenue Code and below the threshold of "lavish and extravagant," the existing disqualification standard unique to Section 274 of the Code. So, despite being the same as other business expenses in the eye of the Code, it was determined to restrict deductibility. The justification used was that this was an element of "personal consumption"—after all, a person has to eat, doesn't he?

A check of the record of the proceeding before this Committee at that time will show that we strongly opposed the reduction when we testified, predicting revenue loss and incorporating studies produced by the Hotel Employees and Restaurant Employees International Union as to job loss. When this change to deductibility was implemented in the late 80's, our country enjoyed a robust, growing economy and the assumption was that our industry could "take the hit" and that there would be no impact. However, that was a false assumption. An independent and as yet unpublished study has recently been compiled by Professor Stephen Hiemstra of the Purdue University Hotel School dealing with the impact of the reduction in the deductibility of business meals and entertainment. The study determined that overall foodservice sales have been subjected to a permanent downward shift of 3.4% of sales. For example, in 1991 the drop was $6.5 billion attributable solely to the tax change, according to Hiemstra.

As the study points out, there are a number of factors which affect foodservice sales. Positive factors include increases in populations and growth in income. Another positive factor for the lodging industry was the inclusion of the "banquet exception." This was a 2-year transition rule on behalf of the lodging and foodservice industries, keeping deductibility at 100% on certain large meal functions which met certain criteria. It recognized the fact that these events were frequently scheduled long in advance of the actual date of occurrence; in many cases years in advance, in reliance on existing tax laws. We believe this exception also was a recognition of the unique "non-personal" consumption which takes place at large group functions. It was an appropriate exception and it helped delay for several years employment dislocation and revenue loss.

However, all factors exert an influence and the net result is total sales. The Hiemstra study isolated the loss attributable to the 100% to 80% reduction. The fact that this loss may have been masked by other factors does not mean that the loss did not take place, only that its visibility as a negative impact was clouded.

While predictions of job loss in 1986 covered a broad range, and the "masking" effect discussed above made subsequent measurement difficult, it seems undeniable that if there if a permanent loss of sales, there will be a concomitant loss of employment (or failure to create jobs). While not primarily intended as a measurement of job loss, but rather one of revenue loss in the industry, Hiemstra has subsequently estimated that it would be reasonable to expect that the impact of lost revenue at the level he calculated could lead to job losses in the range of 150,000 or higher overall, with potential lodging losses contributing as many as 25,000 to that total. We admit that's history, and we don't expect this Committee to undo that now. But, neither do we expect it to deny the reality of the loss in the past and the reality that loss will occur in the future.

It is important to note that not all foodservice was impacted equally. In fact, the study opines that foodservice in hotels could feel as much as twice the average impact, or 6% of their sales, which would be a sizable adverse impact, particularly when added to the negative impacts of income in recent years. Food and beverage sales in hotels approximated $20 billion for 1992. If the 6% estimate is accurate, our industry could today be enjoying sales of an additional $1.2 billion annually and could be supporting as many as 30,000 to 35,000 additional jobs.

The conclusion is inevitable: the 1986 change in deductibility had an impact on our industry, measured today by jobs not existing and people not employed in the hotel, motel and restaurant industries. Although obscured by the robust economy of the late 80's and recession of the early 90's, the impact did and does exist.

THE CURRENT TAX PROPOSAL: WHAT'S REALLY AT STAKE

The Ways and Means Committee is currently considering whether it is appropriate to further reduce the deductibility of business meals and entertainment from the current level of 80% to an unprecedented 50%. The driving force behind this continued attack on business meal and entertainment deductibility seems to be one of perception. The easy characterization adopted by the popular press is that of two fat, white, upper class men dining at an elite restaurant. We all know what it's called, "the 3-martini lunch."

Were that the totality of business meals and entertainment deductibility and the totality of the impact, we might well agree with you. But, this perception isn't the smallest part of the story. The range of business activities regulated by Section 274 of the Internal Revenue Code goes far beyond the business meal served in a restaurant.

In the country's full-service hotels the activities covered include:

- The business traveler's own meals, whether eaten in a hotel coffee shop or restaurant, or grabbed on the run from a food cart.
- Refreshments served by companies in convention hotel rooms in the hotel where they display their particular goods in conjunction with a trade show. These rooms are generally known in the trade as hospitality suites.
- Banquets held in hotels as part of a convention or trade show, as a company-sponsored event for employees, or as a freestanding event to draw local business attendees.
- Receptions—stand-up events either as a precursor to or in place of a sit-down banquet meal, again held at conventions, trade shows, by companies, and independently, for local business attendees.
- Food service as part of an extended meeting. This includes the continental breakfast prior to the meeting; the mid-morning or mid-afternoon coffee break and the working lunch: the sandwiches and salads served at the meeting table while the meeting continues. These types of foodservice take place frequently during conventions and trade shows as an industry gathers for an annual meeting sponsored by its trade association and breaks into many component groups to conduct its business.

All of these foodservice activities, the majority of the food and beverage served in hotels, have two things in common. First, the business person consuming the food has no control over what food and beverage is served (with the exception of the business traveler's own meals). This lack of choice is significant because one of the primary reasons currently offered to justify the reduction in deductibility is the element of personal consumption—the idea that the person eating and drinking is satisfying personal desire. This option is lacking in the food and beverage events described above and, while hotels take justifiable pride in the quality of their food and its presentation, the actual business consumer "takes it or leaves it."

The second element common to these events is the predominance of the business content attending the food and beverage. When a business sponsors a reception for its customers, hosts a hospitality suite or conducts a working lunch, it does so because the event is conducive to promoting its image, creating an environment to sell its goods or services, or actually conducting its business. Also, a wide range of employees, from sales personnel through middle- and upper-management, are in attendance. These are working sessions, and those producing the work are in attendance.

While many, if not all, of these goals are served at the private business meal, at the larger events typically hosted in hotels as adjuncts to conventions, trade shows and business meetings, the business content is dominant. At these events it is clear, "there is no free lunch."

The second major driving force behind the constant attacks on business meals and entertainment deductibility is the promise of billions of dollars of revenue to the federal coffers if you, the Congress, just lower deductibility. We in the lodging industry have serious doubts about the reasonableness of this request. Firstly, we have seen the revenue estimates and have found no supporting documentation from the Joint Committee on Taxation, the Congressional Budget Office, or the Office of Management and Budget to explain the assumptions made to derive the revenue estimates. We don't believe the stone has that much blood left.

Secondly is the astounding belief, most recently heard by this Committee in response to a question by one of the distinguished members of this panel to the Secretary of the Treasury, concerning the impact of the proposal on convention business. The gentleman was told there would be no impact on our industry, no reaction on the part of the business community, and no change in consumption patterns as a result of a reduction by more than one-third in the deductibility of a legitimate business expense. We understand the gentleman did not find the answer credible, nor do we. That belief should be rejected by this Committee once and for all.

Thirdly, if there were a desire to simply raise revenue, there are more broadly based and fair ways to spread the cost over the business community without concentrating the impact on one industry in the economy. We do not believe it is our role to point the finger at anyone and target them for extra taxes, but we challenge this Committee to avoid burdening our industry a second time on expense deductibility without considering whether others should be burdened a first time in a similar fashion.

We believe it likely that revenue is not there at the levels predicted by Treasury for the simple reason that the patterns of consumption by the business community have changed and will continue to change, lowering the revenue expected by the Treasury and further hurting our business.

HOW MANY JOBS—AND WHERE?
AMERICAN CITIES WILL BE HURT!

It is inevitable and, perhaps, unfortunate that any presentation to this Committee on the deductibility of business meals and entertainment will not be persuasive based on the legitimacy of these expenditures, the mundaneness of the settings in which these activities occur, the unreality of the revenue estimates bandied about or even the simple sense of equity that our industry has sacrificed as much as it should. In the final analysis, what really matters is how many working Americans you will displace from their jobs this time.

As we indicated earlier, the impact from a further reduction in deductibility will not impact all hotels evenly. Those hotels which are limited-service, i.e., that do not serve food, should feel little impact from the change. In fact, as noted, this segment had already returned to profitability, albeit only slightly. The impact will be felt most severely in the full-service segment of our industry and will be concentrated in those hotels catering to business travelers, typified by the large convention hotels found in all major United States cities. These hotels, many with in excess of 1,000 rooms, are major employers in their cities. They provide a broad range of jobs from entry-level through management and, despite the tendency of some to disparage our industry's entry-level jobs, they provide entry into the job market for many young people, women and minorities and those without higher education. These jobs keep people off unemployment and welfare rolls or, in many instances, provide a supplement to income earned from a primary job. We are proud of the jobs our industry has created and the many talented individuals who have moved upwards from these beginnings. These employees are not faceless numbers to be totaled up and discarded as Congress and the Administration tilt at the windmill of personal consumption. They are tax paying, contributing citizens of our major cities and are entitled to this Committee's respect and compassion.

How many will you sacrifice? As stated earlier, there was an impact from the 1986 reduction. In order to determine the impact from the current proposal, the National Restaurant Association researched the issue of job loss and concluded an industry loss for foodservice with business meal clients of 165,000. We believe this is a conservative estimate of the impact across foodservice and we have no hesitancy in endorsing that amount of job loss. While it is possible that circumstances may push job loss higher, their estimate is a reliable minimum. We would note, however, that the figure represents what is

called full-time equivalents and the total number of real individuals, real people losing their jobs, will include part-time as well as temporary or seasonal employees. That means that the total number of people actually becoming unemployed will likely be well in excess of 165,000. Whether the job loss is full-time, and the only source of income, or part-time, and a needed supplement to meet expenses, the loss of that job will create economic pain. We further note that in this time of economic malaise, there is not likely to be the masking effect previously enjoyed. This time, job loss will be visible and countable.

Lodging's share of the job loss predicted by the National Restaurant Association can reasonably be expected to be in the range of 15% to 25% of the total, or 25,000 to 40,000 jobs lost. Again, that is full-time equivalents, and the actual number of full-time, part-time, seasonal and temporary employees actually dislocated will likely be at or above that 40,000-person level. However, this loss will not be spread evenly across the country. The bulk of the full-service hotels and certainly the large convention hotels are located in urban areas. They are big city hotels and the individuals who lose their jobs will be the residents of those cities. Many of these individuals, but by no means all, will be at the lower end of the economic spectrum, working because of the range of entry-level jobs created by lodging properties. When they lose their jobs, many may not have the ability to seek jobs in other industries. It will fall to the cities and states to provide their support through unemployment, medicaid and welfare.

But, the loss to American cities will not just be an increase in the unemployed with the attendant financial burdens this places on government. The travel and tourism industry is a complex organism in a city, typically represented by a convention and visitors bureau. The CVB is a recognition that a traveler to a city, in this case a business traveler, impacts the entire local economy.

If you lower the deductibility from 80% to 50%, business will react in a number of ways. The individual business traveler will trim the number of trips taken and the level of expenses for those trips still taken. At conventions, banquets and the like, the number of attendees will shrink as companies allow fewer employees to attend these functions. The level of expenditures by event sponsors will decline and, as a result, the quality and quantity of food served will decline. These types of shifts will directly impact the revenue of the hotels and its remaining employees. When a banquet shifts from beef to chicken, for example, and the total meal cost is reduced, the income of the hotel is reduced, as is the earning of the waitstaff, which typically receive a percentage of the total costs from the assessed service charge. This reduction of employee income will also carryover into tipped employees serving in restaurants, who will see tips reduced as checks decline and diners trim tips to get the most mileage out of their available travel budgets. This eventually reduces taxes paid to governments at all levels.

The effect doesn't stop there. It is generally recognized that there is a "multiplier effect" from spending in hotels. While the effect varies across the country, it is appropriate to estimate a doubling effect. That is, for every dollar spent in a hotel, a dollar in sales is generated in the city where the hotel is located. This money is spent, for example, on goods and supplies to serve the hotel's guests, as well as spending by employees.

Non-business spending by the business traveler, i.e., sightseeing, souvenirs and the like, whether by the traveler or accompanying spouse, is another source of revenue to our nation's cities. With regard to this type of spending, we decry the new strictures proposed by the Administration with regard to the business deductibility of spousal travel as still another unwarranted burden. Existing law has strict tests which must be met by a spouse before expenses attendant to his or her travel are deductible by the employer of the business spouse. They don't allow a free ride.

The Administration's proposal to require the spouse to be an employee as well as provide appropriate service will only hurt convention-related travel. The employee standard creates a hurdle that many could not overcome due to corporate policy. It will create a chilling effect on spousal travel generally, as corporations view spouses as persona non grata and adopt employee-only policies at their business meetings. This is not a change to raise substantial amounts of revenue; the projection by the Joint Committee on Taxation is only $90 million for five years. We urge the Committee to simply drop their anti-family provision and enforce existing law. When spouses accompany a business traveler, local economies benefit from direct spending and the frequent tacking-on of a personal stay at the end of the business stay.

SUMMARY

In summary, we urge this Committee to retain the deductibility of business meals and entertainment at its current level. The Administration has committed itself to creating jobs through its stimulus package. We find it inconceivable that the Administration would undercut as many as 40% of its effort in that area by destroying at least 165,000 foodservice jobs and exacerbating the loss in major cities where job and revenue loss will be concentrated. The further reduction in deductibility will ripple throughout our economy, particularly in our major cities, causing discomfort and dislocation as spending is curtailed at all levels of business.

American business reacts and does so strongly when its costs of doing business are unfairly driven up. The City of New York recently relearned that lesson. Through a combination of levies, the total tax on a $100 hotel room in New York City is 21.25%. The final straw was an additional 5% hotel tax added in 1990, to raise revenue for the State. The effect was a decline in business for the city, estimated by city Comptroller and former Congresswoman, Elizabeth Holtzman, to exceed $1.1 billion over the last five years. Ms. Holtzman herself also estimated that thousands of jobs were lost; the number could be as high as 6,000 to 8,000 jobs. Now, the situation is so serious that Governor Cuomo is considering repeal of part of the total tax. The refusal of business to go along with this expense is evident.

Congress itself is grappling with reaction to one of its own laws: that of the luxury tax on boats and other so called "luxury items." The parallel is compelling. Congress perceived a conspicuous consumption and thought it could simply tax it and reap the benefits. Instead, purchasers reacted and devastated an industry. Who lost? The Federal Government, of course; because it did not gain revenues and, in fact, lost the various taxes on wages not earned. But, more importantly, the workers building boats lost—they lost their jobs. Now Congress is trying to repair the hurt it caused, but seemingly only on the "one hand," because on the "other hand" it is being led to believe it can simply tax business by reducing the deductibility of business meals and entertainment and reap the benefits of increased revenues. It didn't work with luxury boats, it won't work with business meals and entertainment. An 80% to 50% drop is a steep reduction and foodservice employees and others will lose their jobs as businesses refuse to accept the added expense.

Business will react to cost increase, whether directly, as in occupancy taxes, or indirectly through reduced deductibility of legitimate business expenses. That reaction will hurt the lodging industry, among others, and stall our gradual comeback from recessionary depths. The effects of your actions will be permanent. A further reduction in the deductibility of business meals and entertainment should not be made.

Chairman ROSTENKOWSKI. Thank you, Mr. Leonard.
Mr. Berman.

STATEMENT OF CHIP BERMAN, CO-OWNER AND MANAGER, THE OUTTA THE WAY CAFE, ROCKVILLE, MD, ON BEHALF OF THE NATIONAL RESTAURANT ASSOCIATION

Mr. BERMAN. Mr. Chairman and members of the committee, my name is Chip Berman. I co-own and manage The Outta the Way Cafe in Rockville, MD. We are a neighborhood restaurant that sells a little rock and roll and a lot of cheeseburgers. Nothing fancy and only three things on the menu over $10.

You might be wondering why someone like me is testifying on business meal deductibility. You probably expected Duke Zeibert or Mo Sussman. Well, every day a great many business people bring clients to my restaurant to help market their services and close a deal.

Today, I speak for thousands of middle-class restaurateurs and their employees. Today, I represent Suzetta Harrison and Brenda Bishop, a line cook and a waitress in my restaurant and both single parents with two children each. Suzetta and Brenda are here with me today. These are my people, and this is what this is about.

I might sell rock and roll at night, but at lunch I serve business customers. They are not drinking three martinis. They are working. They are getting in an extra hour doing business by doing it over lunch.

The reduction in the business meal deduction is being billed as a last remaining loophole for rich folks in three-piece suits dining at fancy restaurants, while writing it off on an unsuspecting public. But the facts are that a majority of business meals take place in low to moderately priced restaurants like my own.

A majority of those using the business meal deduction are small businesses. One-quarter are self-employed. In other words, the perception that the only people using the business meal deduction are the proverbial "fat cats" is a myth.

According to an independent study commissioned by the National Restaurant Association, a reduction in the business meal deduction to 50 percent means that $3.8 billion will be lost in business meal sales, causing an estimated 165,000 people nationwide to lose their jobs in restaurants, including 2,900 in Maryland.

I know it will hurt the kind of business lunch trade I do because it is price sensitive. It will cut into my sales, and that will cut into jobs.

Why is Government making it so difficult to employ people if our goal is increased employment?

Every restaurant person I know has cut payroll in the last year. Labor is the only controllable cost left. I cannot change my rent or my utilities or my insurance premiums. I cannot reduce food and beverage costs. I cannot increase the prices I charge my customers.

But I can cut payroll. What will Brenda Bishop, a waitress, do if her tipped income is reduced as a result of these measures? What will Suzetta, who has been with me for 8 years in two different restaurants, do if she can't work at all?

Mr. Chairman, I hear a lot of Government policymakers talking about everyone having to contribute to the economic recovery and

pay their fair share. I might remind you that the restaurant industry has already lost 20 percent of business meal deductibility as a result of the 1986 Tax Reform Act. I also want you to know that when you add up the 25 taxes and fees that I pay to governments at the State, Federal, and local levels—not counting all the other tax measures in President Clinton's package, government gets five times more income than I do—and I own the business.

Local, State, and Federal governments have no clue about the actions each other takes, and all of those actions affect me.

For example, the administration's Btu tax will increase my energy bill an estimated 4.5 percent and cost my business $768 a year. Last year my local government did the same thing, slapping an energy surcharge on my business that right now costs me $1,200 a year.

In the last 2 years, Government has increased my cost of doing business in so many different ways that I have watched our earnings shrink by 46 percent while our gross sales increased by 11.2 percent.

Those of us who have survived this recession know we cannot raise our prices. In fact, my customers are still complaining about the 1991 price increases caused by the increase in the Federal excise tax on alcohol, which lost $212 million in the first 6 months of 1991 over a projected revenue increase of $167 million. The assumption that businesses will simply be able to pass along tax and fee increases to our consumers doesn't cut it in a restaurant like mine. Customers are just too price-conscious.

Let me explain it in terms of what we call cheeseburger logic. My restaurant sells cheeseburgers for $5.25. I net 20 cents.

We are already saving as much as we can without cutting our food quality or our labor costs. If we weren't, we would be out of business already. So if we sold only cheeseburgers and could pay for these new Government costs just by selling more of them, how many additional cheeseburgers would I have to sell?

The proposed Btu tax will cost me $768. So netting 20 cents on each cheeseburger, I will have to sell an additional 3,800 cheeseburgers. If I add everything else that hospitality has to bear in the current package, it is more than 150,000 cheeseburgers. And that is a lot of burgers, more than I could possibly sell in a year.

I ask you to please consider the overall impact of what you are doing. I know my business has to pay some taxes, but I can't even do that if you are going to pass laws like reducing the business meal deductibility that will keep customers from coming in.

So, Mr. Chairman, it all boils down to jobs. If I am left with the choice of reducing labor costs or surviving as a business, which of my people am I going to lay off? And why is my own Government asking me to make that choice, when our common goals are increased employment and a sustained recovery?

Simply put, if the Government is going to impose yet another set of new taxes on restaurants, then maybe the Government should also tell me who to lay off: Suzetta or Brenda?

On behalf of the National Restaurant Association, I would like to submit for the record comments on other aspects of the economic package including our support for the FICA tax on tips credit you

passed twice last year and the permanent extension of the targeted jobs tax credit.

I thank you for your patience.

[The prepared statement and subsequent submission follow:]

Statement of Chip Berman
Ways and Means Committee Hearing
March 31, 1993

My name is Chip Berman. I co-own and manage The Outta The Way Cafe in Rockville, Maryland. We're a neighborhood restaurant that sells a little Rock & Roll and a lot of cheeseburgers. Nothing fancy and nothing on the menu over $11 bucks.

You might be wondering why someone like me is testifying on business meal deductibility. You probably expected Duke Zeibert or Mo Sussman. Well, everyday a great many business people bring clients to my restaurant to help market their services and close a deal.

Today I speak for thousands of middle-class restaurateurs and their employees. Today I represent Suzetta Harrison and Brenda Bishop, a line cook and a waitress in my restaurant and both single parents with two children each. Suzetta and Brenda are here with me today.

I might sell Rock and Roll at night, but at lunch I serve business customers. They're not drinking three martinis. They're working. They're getting in an extra hour doing business by doing it over lunch.

The reduction in the business meal deduction is being billed as a last remaining loophole for rich folks in three-piece suits dining at fancy restaurants, while writing it off on an unsuspecting public. But the facts are that a majority of business meals take place in low- to moderately-priced restaurants like my own.

A majority of those using the business meal deduction are small businesses. And one quarter are self-employed. In other words, **the perception that the only people using the business meal deduction are the proverbial "fat cats" is a myth.**

According to an independent study commissioned by the National Restaurant Association, a reduction in the business meal deduction to 50% means that $3.8 billion will be lost in business meal sales causing an estimated 165,000 people nationwide to lose their jobs in restaurants, including 2,916 in Maryland.

I know it will hurt the kind of business lunch trade I do because it is very price-sensitive. It will cut into my sales, and that cuts into jobs.

Why is government making it so difficult to employ people if our goal is increased employment?

Every restaurant person I know has cut payroll in the past year. Labor is the only controllable cost left. I cannot change my rent or my utilities or my insurance premiums. I cannot reduce food and beverage costs. I cannot increase the prices I charge my customers.

But I can cut payroll. What will Brenda Bishop, a waitress, do if her tipped income is reduced? What will Suzetta Harrison, who has been with me for eight years, do if she can't work at all?

Mr. Chairman, I hear a lot of government policymakers talking about how everyone has to "contribute" to economic recovery and pay their "fair share." I might remind you that the restaurant industry has already lost 20% of business meal deductibility as a result of the 1986 Tax Reform Act. I also want you to know that when you add up the 25 fees and taxes I pay to governments at all levels, not counting all the other tax measures in President Clinton's package, government gets five times more "take home" from my company than I do...and I own it!

Local, state and federal governments have no clue about the actions each other takes that dramatically affect business.

The Administration's BTU tax will increase my energy bill an estimated four and one-half percent and cost my business about $768 a year. But last year my <u>local</u> government slapped on an energy surcharge that already costs me an additional <u>$1200</u> a year.

In the last two years, government has increased my cost of doing business in so many different ways that I have watched our earnings shrink by 46% while our gross sales increased by 11.2%.

Those of us who have survived this recession know we cannot raise our prices. In fact, my customers are still complaining about the 1991 price increases caused by the increase in the federal excise tax on alcohol.

The assumption that businesses will be able to simply "pass along" tax and fee increases to our consumers doesn't cut it in restaurants like mine. Customers are simply too price-conscious.

Let me express it in Cheeseburger Logic. My restaurant sells cheeseburgers for five and a quarter. Of that $5.25, my net profit is twenty cents.

We are already saving as much as we can without cutting our food quality or our labor costs. I cannot raise my prices. So if we sold only cheeseburgers and could pay for these new government costs just by selling more of them, how many additional cheeseburgers would I have to sell?

- The proposed BTU tax will cost me $768. So netting 20 cents on each cheeseburger, I'll have to sell an additional 3,800 cheeseburgers to pay for it.

- An increase in the minimum wage people at the Department of Labor have been talking about will cost $20,500, so I'll have to sell an additional 102,000 cheeseburgers to pay for it.

- The proposed federal excise tax increase on alcohol to fund health care will cost $3,800, so I'll have to sell an additional 19,000 cheeseburgers to pay for it.

- The 1992 state unemployment surcharge increase in Maryland costs me $5,400, so I already have to sell an additional 28,000 cheeseburgers to pay for it.

That adds up to selling 150,000 more cheeseburgers next year. People love our cheeseburgers, but not quite that much.

I ask you to please consider the overall impact of what you are doing. I know my business has to pay some taxes, but I can't even do that if you're going to pass laws like reducing the business meal deductibility that will keep customers from coming in.

So, Mr. Chairman, **it all boils down to jobs.** If I am left with the choice of reducing labor costs or surviving as a business, which of my people am I going to fire? And why is my own government asking me to make that choice?

Simply put, if the government is going to impose yet another set of new taxes on restaurants, then maybe the government should also tell me who to fire – Suzetta or Brenda?

On behalf of the National Restaurant Association, I would like to submit comments on other aspects of the economic package including our support for the FICA tax on tips tax credit you passed twice last year and the permanent extension of the Targeted Jobs Tax Credit. A more detailed analysis of the impact of the package on the foodservice industry will be provided at a later date for the record.

Thank you, Mr. Chairman.

BUSINESS MEAL DEDUCTION FACTS

The deduction for expenses associated with business meals and entertainment was reduced from 100 to 80 percent as a result of the Tax Reform Act of 1986. President Clinton has proposed cutting the deduction to 50 percent, effective January 1, 1994, as part of his economic plan. The 50 percent limit would apply to all business marketing meals, as well as to meals purchased by business travelers. *The National Restaurant Association opposes this limitation for the following reasons:*

I. **THE REDUCTION WOULD RESULT IN JOB, SALES AND TAX REVENUE LOSSES.** In the four years following the Tax Reform Act of 1986, real sales declined almost 6 percent in establishments with per person checks of $15. In fact, the six years following the 1986 change were the worst years the foodservice industry had seen in decades. Real sales in all tableservice restaurants actually dropped in 1990 and 1991, and rose only a slight .1% in 1992. Recent figures on a reduction to 50 percent indicate that 165,000 jobs will be lost and that the industry will see an annual loss of $3.8 billion in sales.

CONSIDER THESE FACTS:

- *A majority of those employed in foodservice occupations are women.* Twenty percent are teens, 12 percent are African-American, and 12 percent are Hispanic – those least likely to withstand economic dislocation.

- *A majority of those purchasing business meals are small business people.* A survey commissioned by the National Restaurant Association shows that seventy percent of those purchasing business meals had incomes below $50,000 and 39 percent had incomes below $35,000.

- *Fully one-quarter of those purchasing business meals are self-employed.*

- A drop in business meal traffic affects far more than "fine dining" restaurants. *Low- to moderately- priced tableservice restaurants are the most popular type of restaurant for business meals.* Seventy-eight percent of business lunches and 50 percent of dinners occur at these establishments. The average amount spent on a business meal, per person, is $9.39 for lunch and $19.58 for dinner.

- Over the last decade, U.S. cities have invested millions of dollars to attract people and businesses to downtown areas. Business travelers are a significant part of this revitalization. By reducing the deduction for business and travel meals, the federal government is creating a disincentive for such activities. Federal revenues might increase – but local and state economies and treasuries would suffer.

II. **PLACING A LIMIT ON THE DEDUCTION WOULD TAKE A SPECIAL TOLL ON SMALL BUSINESSES.** Many businesses, particularly small businesses, rely on restaurant meals to give them an opportunity to sell their products and services one-on-one. For many of these business people, other forms of advertising – such as radio, TV or newspaper ads – are either too expensive or not effective. Reducing the deduction unfairly penalizes the small business people who use it and the small foodservice businesses they frequent.

III. **THE BUSINESS MEAL IS A LEGITIMATE MARKETING TOOL.** Like other sales-generating expenditures that are fully deductible (advertising, promotions, free samples, etc.), the business meal is an integral part of the marketing plans of many firms. It is not right for the U.S. government to inject itself into the private decisions a business makes about which marketing techniques work best.

WHY CONGRESS SHOULD ENACT H.R. 1141

Sponsored by Rep. Mike Andrews (D-TX) and Rep. Don Sundquist (R-TN)

What are FICA taxes on tips? --

Current law requires both employers and employees to pay Social Security (FICA) taxes on all tip income earned by employees.

What this legislation would do --

H.R. 1141 would address a provision of the Omnibus Budget Reconciliation Act of 1987 which requires employers to pay FICA taxes on all employee tip income. Under the prior law, employers paid FICA taxes on all wages they paid directly to employees. Employers paid FICA taxes only on tips used as a credit up to the minimum wage. H.R. 1141 would still require employers to pay FICA taxes on all tips, but would provide an income tax credit for sums above the amount considered wages by the Fair Labor Standards Act.

Why current law is unfair --

Federal law treats all employee tip income as employer-provided wages for tax purposes, while only treating $2.12 cents per hour as wages for purposes of meeting the minimum wage. This is inconsistent, and has cost restaurants hundreds of millions of dollars and thousands of jobs.

Why all tips shouldn't be considered wages --

Tipping is a private transaction between patron and server over which the employer has no control. Tip income is earned independent of the employer. Restaurateurs should not be forced to pay payroll taxes on non-payroll income.

Why this tax was enacted --

Congress enacted the FICA tax on tips provision to raise federal revenues to meet the FY 1988 Gramm-Rudman-Hollings deficit reduction targets. The increased revenues were not needed by the Social Security Trust Fund, nor do they provide any increase in retirement benefits for tipped workers. It is wrong to increase Social Security taxes to balance the federal budget.

The FICA tax on tips is costly to tipped businesses --

The FICA tax on tips has been financially devastating to the foodservice industry -- particularly small restaurants. Over 70 percent of eating and drinking places have annual sales of less than $500,000 per year -- with an average pre-tax profit between 3 and 5 percent of sales. The FICA tax on tips costs many small restaurants more than $10,000 each year -- a cost that is unpredictable and cannot be budgeted for. It has completely eliminated any profit for many struggling enterprises, curbing job creation and economic growth.

The law disrupts employer-employee relations --

Whereas U.S. labor law stipulates that all tip income belongs to the employee, the FICA tax on tips now creates a direct financial interest for employers in the private tip transaction between patron and server. The provision also creates a potential tax liability for employers when employees fail to report all tip income. This has resulted in unexpected back tip assessments against employers who have been complying with tip reporting laws in complete good faith. The law has worsened employer-employee relations while imposing additional paperwork and recordkeeping burdens on small businesses.

What legislative activity occurred last Congress? --

This proposal passed the House and Senate as a provision of both tax bills which President Bush subsequently vetoed. The House bill from last Congress, H.R. 1472, had 275 cosponsors of which 140 were Democrats and 135 were Republicans.

*****TO COSPONSOR H.R. 1141, CONTACT TOM MORGAN (REP. ANDREWS) AT 225-7508. FOR MORE INFORMATION, CONTACT LEE CULPEPPER AT THE NATIONAL RESTAURANT ASSOCIATION, AT 331-5900.*****

TARGETED JOBS TAX CREDIT

What is the Targeted Job Tax Credit (TJTC)?

TJTC is a federal tax credit offered to employers of individuals from nine target groups, including economically disadvantaged youth (18-22) physically or mentally handicapped persons, Vietnam-era veterans, ex-felons, AFDC and general assistance recipients, and SSI recipients. The program also includes hiring of economically disadvantaged youth aged 16-18 years for the summer months. The credit was established in 1979 to encourage employers to hire workers from these groups that chronically experience high unemployment.

Employers can earn a credit of 40 percent of the first $6,000 of qualified first-year wages paid to eligible employees.

Are employers utilizing the program?

To date, close to six million disadvantaged Americans have been hired through TJTC, roughly 500,000 per year. Participants have come from each target group and every state.

Is permanent extension of the program important?

Yes. The uncertainty of benefit availability discourages even broader participation in the program. Any special recruiting program such as this one has start-up costs, and requires advance financial planning. The uncertainty of the extension process automatically disqualifies a number of operators.

Administration's Economic Package

The Administration's economic package includes a permanent extension of the TJTC. It does not, however, include 23- and 24-year-olds.

Position of the National Restaurant Association

The National Restaurant Association supports the inclusion of the permanent extension of the Targeted Jobs Tax Credit in the President's economic package and was pleased that it was made retroactive to June 30 , 1992.

We support this program as it is highly used by the foodservice industry to employ economically disadvantaged individuals. We would, however, recommend that a provision be added which would expand the TJTC to apply to 23- and 24-year-olds.

Leading the Foodservice/Hospitality Industry

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Malcolm Knapp

Assessing the Impact of Limiting Business Meal Deductibility to 50 Percent

Summary

Further limiting the deductibility of business meals to 50 percent from the current level of 80 percent has significant consequences for the foodservice industry including

— a decline in business meal expenditures of nearly $3.8 billion or approximately 10 percent in 1993
— a loss of nearly 165,200 jobs.

An explanation of the assumptions, methodology and sources used to develop these estimates follows.

Business Meal Expenditures

Business meal spending, including both travel and entertainment meals, is estimated at $38,038,715,000 in 1993. Expenditures for meals by entities not subject to federal income taxes, such as nonprofit organizations and government, account for 11.8 percent of the total or $4,488,568,000 in 1993. The remaining expenditures totaling $33,550,147,000 in 1993 are attributed to entities subject to federal income taxes.

The section on methodology describes how the estimated dollar volume for business meal expenditures was developed.

Loss of Expenditures at 50 Percent Deductibility

The estimated loss is based on the assumption that businesses and other spenders will maintain the same after tax expenditures if deductibility is further limited to 50 percent from its current level of 80 percent for business marketing and travel meals. This assumption represents the logical upper limit of loss.

Business meal expenditures will decline by nearly 10 percent or $3,764,163,000 based on this assumption.

Calculation of this dollar loss is straight forward. The current after tax cost of $100.00 in deductible business meals is 80% x 34% tax rate (using the corporate rate which is applicable for the vast majority of expenditures). This calculation equals a tax reduction of $27.20 for an after tax cost of $72.80. Therefore, the after tax cost of business meal expenditures totaling $33,550,147,000 is $24,424,507,000.

If deductibility is reduced to 50 percent from 80 percent, the after tax cost is 50% x 36% (using the proposed corporate tax rate). This yields a tax reduction of $18.00 for an

after tax cost of $82.00.

To preserve the same after tax cost of $24.4 billion at 50 percent deductibility as currently exists with 80 percent deductibility, total business meal spending by entities subject to federal income taxes must be trimmed to $29,785,984,000. This is a decline of $3,764,163,000 or nearly 10 percent.

Hours and Jobs Lost

A decline in expenditures for business meals totaling $3,764,163,000, represents 165,198 industry jobs lost.

This is calculated based on total sales per full time equivalent employee working 35 hours per week of $31,900 at full menu tableservice restaurants derived from Restaurant Industry Operations Report, 1991. This works out to sales of $911.43 per annual hour ($31,900 ÷ 35 hours = $911.43)

The business meal sales loss of $3,764,163,000 equates with a loss of 4,129,953 annual hours ($3,764,163,000 ÷ $911.43 = 4,129,953).

To convert annual hours lost into jobs lost, the annual hours figure is divided by 25 hours, the average weekly hours worked per nonsupervisory employee in eating and drinking establishments, according to the Bureau of Labor Statistics (4,129,953 ÷ 25 = 165,198).

Methodology

To make an estimate of the size of the market for business marketing/entertainment meals and business travel meals, two approaches, which yielded substantially the same result, were used. The estimate is consistent with the National Restaurant Association's 1993 annual forecast of the size and scope of the foodservice industry, part of a series of annual industry estimates reporting comparable data from 1970-1993.

One approach used unpublished data from the Consumer Expenditure Survey conducted by the Bureau of Labor Statistics. This survey provided data for personal consumption expenditures which was used in conjunction with total sales estimates to derive business meal estimates for segments of the industry where business meals are purchased. These segments include the following

- all eating places (excluding contract foodservice)
- drinking places
- foodservice contractors at manufacturing and industrial plants; commercial and office buildings; recreation and sports centers
- lodging places
- retail hosts
- bowling lanes
- movie theaters
- recreation and sports centers

- vending
- mobile caterers
- industrial and commercial foodservice -- self operated
- passenger lines
- railroads
- clubs

Excluded is foodservice at other places such as colleges and universities, hospitals, primary and secondary schools, airlines, nursing homes and community centers.

Business meals represent 16.44 percent of the 1993 foodservice sales base described above.

The second approach used was to develop estimates based on a comprehensive consumer survey of business meal spending conducted in 1988 by M/A/R/C Inc. coupled with industry anecdotal survey data on the proportions of business marketing meals and travel meals. For the lodging segment, Consumer Expenditure Survey data was cross referenced with hospitality industry surveys.

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EMPLOYMENT IMPACT OF REDUCING THE BUSINESS MEAL TAX DEDUCTION

The following is based on an analysis of the impact of reducing the business meal deduction from 80% to 50% as proposed in President Clinton's economic package. The estimated loss of jobs and sales is based on the assumption that spenders will maintain the same after-tax expenditures for business meals which would result in less business meal spending. Consumer surveys done by the National Restaurant Association show that most business meal spenders would reduce business meal activity despite the fact that they believe meals serve an important purpose in meeting their marketing and sales objectives.

1993 business meal market	**$38,038,715,000**
Expenditures by nontaxable entities (nonprofits, governments, etc.)	**$4,488,568,000**
Expenditures by taxable entities	**$33,550,147,000**
Loss in sales for 1993	**$3,764,163,000**
Loss in jobs	**165,198**

Estimates prepared by Malcolm Knapp, Inc.

State-by-State Impact of Limiting Business Meal Deductibility from 80% to 50%, 1993

	Business Meals (000)	$ Loss (000)	Job Loss
U.S.	$38,038,715	$3,764,163	165,198
Alabama	407,804	40,363	1,771
Alaska	128,603	12,726	558
Arizona	645,775	63,892	2,804
Arkansas	215,932	21,371	937
California	5,229,231	517,508	22,711
Colorado	603,866	59,752	2,622
Connecticut	512,126	50,684	2,225
Delaware	104,289	10,321	453
D.C.	305,297	30,196	1,326
Florida	2,582,744	255,544	11,215
Georgia	1,006,916	99,641	4,373
Hawaii	624,574	61,775	2,711
Idaho	113,261	11,208	491
Illinois	1,616,834	160,003	7,022
Indiana	645,102	63,847	2,802
Iowa	299,363	29,628	1,301
Kansas	291,628	28,863	1,266
Kentucky	431,136	42,670	1,872
Louisiana	521,732	51,630	2,266
Maine	197,548	19,549	858
Maryland	671,253	66,433	2,916
Massachusetts	1,236,479	122,360	5,370
Michigan	1,116,589	110,512	4,850
Minnesota	629,350	62,279	2,733
Mississippi	206,613	20,448	897
Missouri	744,576	73,681	3,234
Montana	107,618	10,649	467
Nebraska	184,900	18,299	803

State-by-State Impact table continued

	Business Meals (000)	$ Loss (000)	Job Loss
Nevada	1,056,688	104,453	4,584
New Hampshire	220,410	21,810	959
New Jersey	1,323,597	130,952	5,747
New Mexico	212,161	20,995	921
New York	2,623,115	259,583	11,392
North Carolina	893,049	88,388	3,879
North Dakota	78,170	7,735	340
Ohio	1,311,536	129,807	5,696
Oklahoma	361,642	35,789	1,573
Oregon	444,258	43,969	1,930
Pennsylvania	1,551,378	153,517	6,737
Rhode Island	147,589	14,608	642
South Carolina	487,117	48,206	2,115
South Dakota	75,950	7,516	329
Tennessee	613,373	60,701	2,664
Texas	2,271,001	224,749	9,864
Utah	211,178	20,898	917
Vermont	121,630	12,033	528
Virginia	981,780	97,152	4,264
Washington	774,528	76,657	3,365
West Virginia	176,087	17,425	765
Wisconsin	639,713	63,313	2,779
Wyoming	81,625	8,075	354

Notes and Sources: To reach state-by-state estimates, U.S. totals were distributed as follows: Total dollar volume, dollar volume loss and job loss for lodging places were distributed based on state-by-state proportion of total meal and nonalcoholic beverage sales plus alcoholic beverage sales for 1987 from the Census of Service Industries, Subject Series, Hotels, Motels and Other Lodging Places, Bureau of the Census. Total dollar volume, dollar volume loss and job loss for the remainder, excluding lodging places, were distributed based on state-by-state eating place sales estimates for 1993 from National Restaurant Association 1993 Foodservice Industry Forecast. A detailed description of U.S. estimate is given in "*Assessing the Impact of Limiting Business Meal Deductibility to 50 Percent.*" Dollar loss and job loss estimates for the U.S. are based on the assumption that business will maintain the same after tax expenditures at 50 percent deductibility as at 80 percent.

Mr. RANGEL [presiding]. Without objection, all of the written testimony of this panel will be entered into the record.

Mr. Leffler.

STATEMENT OF MARVIN LEFFLER, CHAIRMAN OF THE BOARD, NATIONAL COUNCIL OF SALESMEN'S ORGANIZATIONS, INC.

Mr. LEFFLER. Mr. Chairman, distinguished members of the committee, my name is Marvin Leffler. I appreciate the opportunity of appearing before you, which I do as chairman of the Board of the National Council of Salesmen's Organizations.

We represent 55,000 commissioned salesmen who either individually or through affiliated groups are members of NCSO. Our members are engaged in more than 100 industries, running the gamut from aerospace to yarn, but the common bonding thread between us is that we are all commissioned sales representatives who pay our own expenses and derive no income other than the compensation for goods and services actually sold.

In addition to my unsalaried work with NCSO, I have more than 40 years of personal experience as a sales representative. I have authored two widely distributed books, relating to the position of the sales representative in our economy and have been concerned on a daily basis with the growing problem of those who earn a living as commissioned sales representatives.

Our concern today is not with the President's desire to deal with the deficit. We fully understand the need and sincerely hope that his ultimate goal will be achieved. We do, however, have serious doubts that it will be beneficial for the economy to further limit the deductibility of T&E expenses or to further increase the taxability of Social Security payments to those who earn $25,000 as individuals or $32,000 as couples.

Since others will, I am sure, deal in depth with the unfairness of burdening senior citizens with relatively modest incomes to the extent of an 85-percent inclusion of Social Security funds as taxable income, I merely want to record our objections at this time and to state that we feel it totally unfair to further tax money which was taxed originally as income when, at age 65, it finally comes back to those who thought they were contributing to their future during the 40 to 50 years they worked before becoming eligible. IRA, Keogh, 401(k), and other pension plans are taxed only once, when received. Is it really fair to tax the most universal pension of all, Social Security, twice?

Permit me now to move on to the subject of greatest concern to our constituents, the proposed reduction from 80 percent to 50 percent of the entertainment expenses.

There are, in my judgment, only two possible justifications for the adoption of the proposal to limit further entertainment deductions. One would be to stop overwhelming abuse, and the other would be to raise revenue more fairly. The proposal can be faulted on both counts.

The overwhelming majority of expense accounts are utilized in the proper promotion of business activities. The present IRS regulations, properly enforced, protect more than adequately against abuse.

For example, club dues, to be deductible, must be substantiated by the maintenance of a log to prove the club was used more than half the time to entertain customers. The names, business relationship, and purpose of the get-together must be noted.

Business meals are well defined in current regulations. They must be associated with or directly related to a legitimate and defined business purpose.

Admittedly abuses can and do occur, but the penalties of fraud are present, and nothing is gained in this regard by changing the percentage of deductibility.

Beyond a desire to stop abuses, the other and main aim of further limiting deductibility would be to fairly raise revenue for the purpose of reducing the deficit. The truth, in our opinion, is that the gross increase in tax revenue would be comparatively small, and even this gain would be as illusory as the limitation is unfair.

At least 25 percent of those purchasing business meals are self-employed, and in total, 70 percent of those who purchase business meals had incomes below $50,000 and 39 percent had incomes below $35,000. Of necessity, small business in particular would have to curtail sharply entertainment expenses. As they spend less, the income of restaurants, theaters, sports arenas, et cetera, would shrink, as would tax revenue normally collected from them and their employees.

In turn, this would tend to increase unemployment and decrease expenditures for soft and hard goods. The snowball effect would result in a lessening of anticipated tax revenues.

Additionally, the burden placed on sales representatives, for example, would be completely unfair. For the commissioned person, buying lunch and dinner for customers is a time-honored tradition and business necessity, as many if not more sales are made in the quiet solitude of a restaurant or club as in the office where telephone calls and other interruptions play havoc with the sales presentation. The typical representative, if not eating lunch or dinner with a customer, grabs a sandwich on the run at noontime and either has a modest dinner while on the road or has his evening meal at home.

When he entertains a customer, he naturally eats a more expensive meal, but not for self-gratification. He would rather be home. But business exigencies require it.

We can find no justification for the proposal to limit to 50 percent the deduction for legitimate business meals. It defies logic. If a business meal is a business meal, then it is necessary and it is as vital to the production of income as is the machinery of the manufacturer or the stethoscope of the physician.

Offering to allow—one second, please, and I will be finished—half the deduction would be the same as allowing half of business travel expenses or half the cost of paperclips used in the office or half the cost of legislators themselves when on official business. Either the expenses are legitimate, or they are not. They cannot be half legitimate any more than one can be half pregnant. And if they are legitimate, they should be the way they are and preferably back to the way they used to be at 100 percent.

Thank you very much, and we urge you to consider our plea most carefully and stay what could be a final blow to our sales industry and counterproductive to the attainment of your objectives.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF MARVIN LEFFLER
CHAIRMAN OF THE BOARD
NATIONAL COUNCIL OF SALESMEN'S ORGANIZATIONS
TO THE COMMITTEE ON WAYS AND MEANS
IN CONNECTION WITH HEARINGS ON PRESIDENT CLINTON'S
PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

MARCH 31, 1993

Mr. Chairman, Distinguished Members of the Committee:-

My name is Marvin Leffler. I appreciate the opportunity of appearing before you, which I do as Chairman of the Board of the National Council of Salesmen's Organizations. We represent 55,000 commissioned salesmen who, either individually or through various affiliated groups, are members of N.C.S.O.

Our members are engaged in more than one hundred industries running the gamut from aerospace to yarn, but the common bonding thread between us is that we are all commissioned sales representatives who pay our own expenses and derive no income other than the compensation for goods and services actually sold.

In addition to my unsalaried work with N.C.S.O., I have more than forty years of personal experience as a sales representative, have authored two widely distributed Prentice-Hall books relating to the position of the sales representative in our economy, and have been concerned on a daily basis with the growing problem of those who earn a living as commissioned sales representatives.

Our concern today is not with the President's desire to deal with the deficit. We fully understand the need and sincerely hope that his ultimate goals will be achieved. We do, however, have serious doubts that it will be beneficial for the economy to further limit the deductibility of T & E expenses or to further increse the taxability of Social Security payments to those who earn $25,000 as individuals or $32,000 as couples.

Since others will, I'm sure, deal in depth with the unfairness of burdening senior citizens with relatively modest incomes to the extent of an 85% inclusion of Social Security funds as taxable income, I merely want to record our objections at this time and to state that we feel it totally unfair to further tax money which was taxed originally as income when, at age 65, it finally comes back to those who thought they were contributing to their future during the 40 to 50 years they worked before becoming eligible. IRA, Keogh, 401K, Single Premium Life and other pension plans are taxed only once - when received. Is it really fair to tax the most universal pension of all - social security - twice?

Permit me now to move on to the subject of greatest concern to our constituents -- the proposed reduction from 80% to 50% of the entertainment expenses which will be permitted should the Congress so decree.

There are, in my judgement, only two possible justifications for the adoption of the proposal to limit, further, entertainment deductions. One would be to stop overwhelming abuse and the other would be to raise revenue more fairly. The proposal can be faulted on both counts.

The overwhelming majority of expense accounts are utilized in the proper promotion of business activities. The present IRS regulations, properly enforced, protect more than adequately, against abuse.

For example, club dues to be deductible, must be substantiated by the maintenance of a log to prove the club was used more than 50% of the time to entertain customers. The names, business relationship and purpose of the get-together must be noted.

Business meals are well define in current regulations. They must be associated with, or directly related to, a legitimate and defined business purpose. If an examining agent ascertains that a taxpayer is substituting business meals for his own regular meals, he can invoke the Sutter rule which would allow the deduction only for the customer's portion.

Admitedly, abuses can and do occur, but the penalties of fraud are present and nothing is gained in this regard by changing the percentage of deductibility.

Therefore, to prevent those like the commissioned sales representatives we represent from taking what is to them ordinary and necessary business deductions for customer entertainment in order to try to stop those tho flout present regulations, is to punish the majority who are innocent in order to get at the tiny guilty minority.

Beyond the desire to stop abuses, the other and main aim of further limiting deductibility of entertainment expenses would be to fairly raise revenue for the purpose of reducing the deficit.

The truth, in our opinion, is that the gross increase in tax revenue would be comparatively small and even this gain would be as illusory as the limitation is unfair. At least 25% of those purchasing business meals are self-employed and in total, 70% of those who purchase business meals had incomes below $50,000 and 39% had incomes below $35,000. Of necessity, small businesses, in particular, would have to curtail sharply entertainment expenses. As they spend less, the income of restaurants, theatres, sports arenas, etc. would shrink, as would tax revenue normally collected from them and their employees. In turn, this would tend to increase unemployment and decrease expenditures for soft and hard goods. The snowball effect would result in a lessening of anticipated tax revenues.

Additionally, the burden placed on sales representatives for example, would be completely unfair. To the commissioned person, buying lunch and dinner for customers is a time-honored tradition and a business necessity. As many, if not more sales are made in the quiet solitude of a restaurant or club as in the office where telephone calls and other interruptions play havoc with the sales presentation.

The typical sales representative, if not eating lunch or dinner with a customer, grabs a sandwich on the run at noontime and either has a modest dinner while on the road or has his evening meal at home, with his family at a cost far less then the restaurant would charge. When he entertains a customer, he naturally eats a more expensive meal, but not for self-gratification--he would rather be home-- but becuase business exigencies require it.

The business meal is part of the sales representative's frequent 14-hour day. It enables him to squeeze out additional hours for selling goods, conferring with principals and customers, and thus saving normal hours for additional calls. The business meal is thus a tool of business and not an instrument for pleasure.

We can find no justification for the proposal to limit to 50% the deduction for legitimate business meals and other such expenses. It defies logic. If a business meal <u>is</u> a business meal, then it is necessary and as vital to the production of income as the machinery of the manufacturer or the stethescope of the physicial, Offering to allow half the deduction would be the same as allowing half of business travel expenses or half the cost of paper clips used in the office or half the costs of the legislators themselves when on official business. Either the expenses are legitimate or they are not---they can't be half legitimate anymore than one can be half pregnant.

And if they are legitimate, they should not only be 80% deductible as they are now due to bad judgement a few years ago, but they should be 100% deductible as are all other business expenses.

What we are really dealing with here under the banner of deficit reduction is a tax increase of substantial and crippling proportions to those like America's entrepreneurial sales representatives, who are least able to pay and who have no way to recover if you lay this heavy burden upon them.

We urge you to consider our plea most carefully and to stay what could be a final blow to our sales industry and counter-productive to attainment of your objectives.

Thank you very much.

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Mr. RANGEL. Thank you.

George Wachtel, director of research and governmental relations, League of American Theaters and Producers.

STATEMENT OF GEORGE A. WACHTEL, DIRECTOR, RESEARCH AND GOVERNMENT RELATIONS, LEAGUE OF AMERICAN THEATRES AND PRODUCERS, NEW YORK, NY, ON BEHALF OF THE THEATER AND PERFORMING ARTS COALITION

Mr. WACHTEL. Good morning, Mr. Chairman, Mr. Rangel, and members of the committee.

My name is George Wachtel. I am director of research and government relations for the League of American Theatres and Producers, and with me today, behind me, are James Randolph, who is president and chief executive officer of the Tennessee Performing Arts Center, and Steven Richard, who is executive director of the Arena Stage Theater, a nonprofit professional theater in Washington.

In addition to representing the League, I am representing the Actors Equity Association and its 36,000 members nationwide; the International Alliance of Theatrical Stage Employees and its 75,000 members; the League of Resident Theaters; the Theater Communications Group; and the National Alliance of Musical Theaters. These organizations represent diverse interests in the performing arts, including labor, the nonprofit theater, and the commercial theater.

All of these organizations are intensely concerned about the fragile nature of the arts today and the prospects for the future.

I have submitted testimony dealing with the impact of the proposed reduction in the business entertainment deduction on Broadway theater and the performing arts. And in particular, I would like to mention something that just was released today. It is in today's paper. This is a press release from the Theater Communications Group, which is a service organization of the nonprofit professional theater in America, and dated March 31, 1993, it reads:

> Nonprofit professional theaters throughout the United States suffered great losses in the midst of the economic recession gripping the Nation.
>
> The worst economic recession in two decades took a heavy toll on the Nation's theaters in 1992. The erosion of public sector funding in the form of crippling cuts in State and Federal Government grants, along with a first time drop—I will repeat—a first time drop in corporate giving seriously affected the theater's contributed income, and earned income grew only enough to keep pace with inflation.

The 1992 survey incorporates information from 182 nonprofit professional theaters located in 112 towns and cities and 36 States and the District of Columbia.

It continues:

> To hold the line on expenses for the second consecutive year, more than half of the sample theaters hired fewer full-time administrative and technical employees, while increasing the number of part-time employees in these job categories. The long-term impact of these measures, coupled with the chronic underemployment of theater artists, may be to diminish job opportunities and continue to the growing talent drain to the more lucrative film and television industry.

Gentlemen and ladies, the President's tax proposal includes the reduction, as you know, for the business entertainment deduction from 80 to 50 percent. The result would be an additional blow to the already fragile condition of the theater and performing arts.

Nearly half of the Nation's nonprofit professional theaters ended the 1991 fiscal year in the red for an aggregate deficit of $2.8 million. And as today's press release points out, that aggregate deficit increased by more than 100 percent from 1991 to 1992 and now stands at $6.5 million.

Nonprofit professional theater attendance dropped in the 1991 fiscal year for the first time in the history of the survey, which began in 1974. Now that is the nonprofit professional theater, which is all too familiar with the issues of deficits.

The Broadway theater is virtually 100-percent dependent upon ticket sales for its income. It receives no subsidy, no contributions, nor does it benefit from broadcast revenues, as do sports teams. Only one out of five Broadway shows ever returns its investment. Fewer new shows are being produced each and every year. In the 1980–81 season there were 60 new productions on Broadway; in the 1990–91 season, there were only 28 new productions. And as you know, the theater and the performing arts budgets are extremely labor-intensive; 60 percent of nonprofit professional theater budgets pay for artistic, administrative, and production personnel, while 62 percent of Broadway theater expenditures are for union labor and artistic royalties. There are 16 theatrical trade unions and guilds.

All of you have heard of, I am sure, "The Phantom of the Opera," of "A Chorus Line," of all the hits. But the hits represent a small minority of the shows on Broadway. Of the 20 or so shows running on Broadway at any given time, only a handful are outright hits. The majority are either attempting to recoup their initial investment or are holding on until they close, often at a sizeable if not total loss. Most shows operate at such close margins that the loss of any portion of income would force them to close.

The reduction in the deduction from 80 to 50 percent will result in a weekly box office loss across the board for shows on an average of 6 percent. And while that may not seem like a lot, if the average operating cost of a Broadway musical is $400,000, and it is bringing in $405,000, if you knock off 6 percent of that, you are going to close. And about 30 percent of the Broadway shows that are currently running are operating that close to the margin, and, in fact, they will suffer that defeat.

What does this mean in terms of jobs? It is not just the actors, the musicians, the stagehands, and the others that work in the theater crafts themselves, but it is the fact that theater creates jobs. Theatergoers dine out; they travel to their destination; they stay in hotels; they shop at retail stores; they consume other entertainment. Less frequent theater attendance means less business at restaurants and other theater-dependent activities. Theatergoers spend on the average between one and two times as much as their theater tickets on these theater-related expenditures.

I do not have time, obviously, to go into the details of the calculations, but I will say that the entire theater and performing arts industry will have a very small impact on the Treasury if this is enacted, and yet the legislation would have a tremendous impact on the theater industry.

In closing, I would like to say, there are three points I would like to leave you with: one, that theater and the performing arts create

jobs; two, because of their location, they spur urban development; and three, because of the tremendous amount of overseas travel of theater and theater companies, they are an export product that create a favorable balance of trade.

I urge you to continue the present level of tax deductibility for business entertainment.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF
GEORGE A. WACHTEL
DIRECTOR
RESEARCH AND GOVERNMENT RELATIONS
THE LEAGUE OF AMERICAN THEATRES AND PRODUCERS

THE IMPACT OF THE PROPOSED REDUCTION IN THE BUSINESS ENTERTAINMENT DEDUCTION ON BROADWAY THEATRE AND THE PERFORMING ARTS

Good morning, Mr. Chairman and members of the committee. My name is George A. Wachtel. I am Director of Research and Government Relations for The League of American Theatres and Producers. I am delighted to be here this morning representing, in addition to The League: Actors' Equity Association, The International Alliance of Theatrical Stage Employees, The League of Resident Theatres, Theatre Communications Group, and the National Alliance of Musical Theatres. These organizations represent diverse interests in the performing arts, including labor, the nonprofit theatre, and the commercial theatre. All of these organizations are intensely concerned about the fragile nature of the arts today and the prospects for the future.

The Fragile Condition of the Performing Arts

The President's tax proposal includes a reduction in the business entertainment deduction from 80 percent to 50 percent. The result would be an additional blow to the already fragile economic condition of the Broadway Theatre and the performing arts.

Nearly half of the nation's nonprofit professional theatres[1] ended the 1990-91 fiscal year in the red for an aggregate deficit of $2.8 million. Seven theatres ceased operation in 1991, bringing the five-year total to 25 closed theatres. Nonprofit professional theatre attendance dropped in that season for the first time in the history of the survey.

Fifty percent of symphony orchestras[2] carry deficits, an increase from 47 percent in 1980-81. Support from government sources for orchestras shrank from 9 percent of their budgets in 1990 to 8 percent in 1991. In 1980-81, government funding represented 13 percent of total income. During the past decade, four orchestras shut their doors, and others have been forced to reduce their seasons.

Forty-nine percent of opera companies[3] posted deficits -- the same percentage as the year before -- but the aggregate deficit for these companies tripled. Public support for opera dwindled nearly one percentage point to 1.6 percent of all income. For the first time in more than five years, contributions from individuals and corporations dropped in 1990-91, mirroring the hard economic times.

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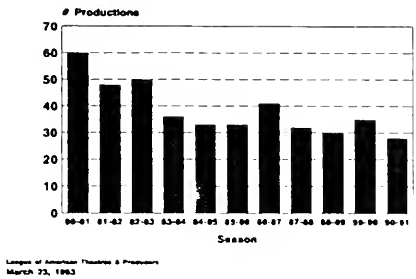
[1]90 of 184 theatres in the Theatre Communications Group's survey, "Theatre Facts 91." The first survey was conducted in 1974.

[2]American Symphony Orchestra League survey of 118 of the largest orchestras in the United States.

[3]Opera America which surveyed 53 nonprofit professional opera companies.

Of the 46 dance companies[4] surveyed, 16 (35 percent) reported deficits. Among the eight ballet companies, the average deficit was $327,693. The eight other companies reported an average deficit of $81,701.

NEW BROADWAY PRODUCTIONS
1980-81 thru 1990-91 Seasons



The Broadway Theatre is virtually 100 percent dependent on ticket sales for its income. It receives no subsidy nor does it benefit from broadcast revenues as do sports teams. Only one out of five Broadway shows ever return their investment. Fewer new shows are being produced each year. Witness the decline from 60 new productions in the 1980-81 season to 28 in 1990-91. Broadway theatre pays municipal, state, and federal taxes.

Theatre and performing arts budgets are extremely labor intensive. Sixty percent of regional theatre budgets pay for artistic, administrative, and production/technical personnel, while 62 percent of Broadway theatre expenditures are for union labor and artistic royalties. The largest portion of dance company budgets is also devoted to personnel, comprising 55 percent of total expenses. And personnel expenses for opera companies reached a new high, accounting for 65 percent of all costs.

Income Loss from Reduction of the Business Entertainment Deduction

Of the twenty or so shows running on Broadway at any given time, a handful are outright hits, but the majority are either attempting to recoup their initial investment or holding on until they close, often at a sizeable, if not total, loss. Most shows operate at such close margins that the loss of any portion of income would force them to close.

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[4] Dance/USA has 46 member companies: 25 ballet and 21 modern and other genres.

The reduction in the deduction from 80 percent to 50 percent would reduce business spending on entertainment an estimated 30 percent.[5] Ticket brokers account for almost 10 percent of Broadway theatre sales, almost all of which are for business entertainment. Furthermore, credit card sales and other sources of information suggest that total business entertainment sales are on the order of 20 percent. *Thus, a reduction of 30 percent in these ticket sales would result in a weekly box office loss of six percent.*

Operating costs for Broadway musicals range from approximately $350,000 to $500,000 per week. The average weekly gross box office (ticket sales) is $413,000. A musical with weekly operating expenses of $400,000 might stay open while weekly ticket sales average $403,000. However, a six percent reduction in the ticket sales, which would reduce weekly income to $380,000, would close the show.

Just how many shows are in this category?

At the present time, about 30 percent of the Broadway shows are operating close enough to their minimal weekly operating expense that a reduction in ticket sales could force them to close. Additionally, even the greatest hits would have shorter runs. Any show which loses a percentage of its potential audience will suffer to the degree of that loss.

The result of shows closing means lost jobs for actors, musicians, stagehands, ushers and ticket takers, wardrobe personnel, hairdressers, box office treasurers, mail and telephone order clerks, advertising personnel, house and company managers, administrative personnel, accountants, lawyers, even tutors for the children in the cast. A typical Broadway musical employs over 100 people -- all union personnel. And when actors and creative people such as designers, authors, directors, and choreographers find less employment in theatre and eventually leave the field, it diminishes the available pool of labor for the other performing arts and entertainment in general.

And the losses do not stop there! Theatregoers dine out, travel to their destination (49 percent in New York visit from elsewhere in the United States and other countries), shop at retail stores, and consume other entertainment. Less frequent theatre attendance means less business at restaurants and at other theatre-dependent activities.

Theatregoers' spending on these theatre-related expenditures is estimated to average between one and two times the amount of ticket

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[5]Charles Clotfelter, "Tax-Induced Distortions and the Business-Pleasure Borderline: The Case of Travel and Entertainment," American Economic Review, December 1983, pp.1053-1065.

sales, depending on the market. The closing of just one musical show could result in as much as $42 million in lost ancillary spending and a negative economic impact of $100 million per year.

Where Broadway Theatre and the Performing Arts Fit In

The Treasury Department estimates the impact of the reduction in business meals and entertainment deduction from 80 percent to 50 percent at $16-billion. The increase in revenue would come from the reduction in the allowable expense for meals and entertainment at restaurants, commercials sports, theatre and the performing arts and other entertainment. As shown below, entertainment at Broadway theatre and other commercial theatre activities account for only a fraction of the total.

According to the 1987 Census of Retail Trade (last available) published by the U.S. Department of Commerce, there were 391,303 establishments classified as "Eating and Drinking Places" with total sales of $148,776,497,000 (SIC code 58), 3,184 "Commercial Sports" establishments with receipts of $5,023,194,000 (SIC code 794), and 7,847 "Theatrical Producers, Bands, Orchestras, Entertainers, and Miscellaneous Theatrical Services" (SIC code 792), of which only 3,253 were specifically "Theatrical Producers and Services" (SIC code 7922). Receipts for the entire entertainment category (SIC 792) totaled $4,904,224,000, while receipts for Theatrical Producers and Services were $2,543,391,000.

Activity	SIC Code	Receipts (Billion $)
Eating and Drinking Establishments	58	149
Commercial Sports	794	5
Theatrical Producers, Bands, etc.	792	5
(Theatrical Producers and Services)	(7922)	(2.5)
	Total	$159 billion

Theatrical producers and services represent $2.5 billion in receipts out of a total of $159 billion, or 1.6 percent of meals and entertainment expenditures.

However, this is a significant overestimate. The SIC code 7922, "Theatrical Producers and Services," includes many establishments in addition to legitimate theatre producers, such as producers of live radio and television, talent agents, casting agencies, and costume designers, which are neither ticketed events nor would qualify for a business entertainment deduction.

Conversely, the performing arts are not included in the retail

census as they are not subject to federal income tax. If we temporarily overlook the broad scope of the SIC code and add to it the performing arts ticket sales figures which amount to $890 million[6], theatre and performing arts total $3.4 billion. Thus, theatre and performing arts represent only 2.1 percent[7] of the entire category of meals and entertainment.

Industry data suggests ticket sales for theatre and performing arts amount to about half of that calculated in the census above. Using the data below, the proportion of meals and entertainment accounted for by theatre and performing arts is only 1.1 percent. (Ticket sales below are for the 1991 fiscal year for the performing arts and 1992 for Broadway and national tours.)

	Ticket Sales (million $)
Broadway	292
Broadway national tours	503
Nonprofit professional theatre	203
Other regional music and dinner theatre	225
Symphony	263
Opera	151
Dance	63
Performing Arts Presenters	93

1991 fiscal year, 1992 for Broadway and tours

Total $1.793 billion

Impact on the Treasury

Using the industry total of $1.8 billion, the current 80 percent rule applied to 20 percent of total arts expenditures at a corporate tax rate of 34 percent results in $98 million per year. At a business entertainment deduction rate of 50 percent, assuming expenditures remain constant, and a 36 percent corporate rate, the total would be $65 million, or a difference of $33 million per year. Over the life of the projection, the impact on the Treasury would be on the order of $150 million.

This gain would be offset by losses in federal income tax revenues owing from people who have lost jobs in the arts industry as well as from employees of businesses which rely on the arts to generate income -- restaurants, hotels, transportation, retail stores.

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[6]Represents a very conservative estimate as most performing arts financial data is collected by service organizations through surveys, the response to which are never equivalent to the universe.

[7]$3.39 billion divided by the combined total of $159 billion + 890 million (performing arts).

Broadway as an Export Product

In addition to national tours, Broadway shows and other theatres are licensed for production worldwide. An estimated $10 million in royalties were earned last year for American plays and musicals produced in other countries. Licensed companies are frequently comprised completely of American actors, an American creative team, as well as an American conductor and key musicians. This is especially true of English language productions which is a growing industry overseas.

To indicate the breadth of American theatre overseas, one major licensing company is currently involved in or has licensed for future production shows in: Hungary, Poland, Holland, Belgium, Germany, Austria, Switzerland, Spain, Denmark, South Africa, Columbia, Finland, Bulgaria, Sweden, Argentina, Chile, Namibia, the Bahamas, Japan, Hong Kong, Singapore, the Philippines, Israel, Saudi Arabia, Iceland, France, Norway, Canada, the U.K., Ireland, Australia, and New Zealand.

The 1990 Tony® Award winner for Best Musical, *Jerome Robbin's Broadway*, closed on Broadway without recouping its investment[8], yet toured for ten weeks in Japan paying weekly operating expenses to American cast and crew and earning income for the investors. Many American shows travel to Canada -- all with their American casts. As examples, Broadway's *The Secret Garden* employed 55 people weekly and *Buddy* traveled with 45 people.

In addition to the tours abroad, musicals and plays are licensed in the domestic secondary market for stock, LORT/regional, and amateur productions. While this is not a market for business entertainment, the extent of this secondary theatre audience is enormous. Total royalties paid for performances of U.S. musicals and plays both here and abroad are estimated at $50,000,000 per year, with a potential audience of 30 to 40 million. This is in addition to the figures cited above. The demand for American theatre worldwide continues to depend on the flow of new shows which come from successful new productions on Broadway and at regional theatres nationwide.

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[8]An extremely large cast and extensive rehearsal time contributed to the inability of this well-received musical to earn back its investment on Broadway. It is an prime example of the type of show that business entertainment tickets can make or break, or at least, extent its run long enough to create interest in the show in other markets.

Conclusion

In closing, I want you to understand that what is at risk here is the ability of the American performing arts community to continue to support, develop, and export world-class theatre and performing arts. We have an unique cultural heritage that has benefitted and continues to benefit from the diversity of the American experience. We should be promoting policies that ensure the further development of the arts in America, not policies that put them at risk. I urge you to continue the present level of tax deductibility for business entertainment.

Mr. RANGEL. Thank you.
Mr. Juliano.

STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL EMPLOYEES & RESTAURANT EMPLOYEES INTERNATIONAL UNION, AFL-CIO

Mr. JULIANO. Thank you, Mr. Chairman, members of the committee.

I appear today on behalf of the Hotel Employees & Restaurant Employees International Union. On behalf of Edward T. Hanley, general president of the union, and all of the members who I am privileged to represent, it is once again a pleasure to appear before this distinguished committee as it deliberates on President Clinton's economic package.

The Secretary of the Treasury, Lloyd Bentsen, testified recently before this committee that there will not be one single job lost or less one penny spent by consumers if this proposal is adopted. The implication was clear to us that there was no effect in reducing the deductibility from 100 percent to 80 percent, and that therefore there would be no effect if you reduce it from 80 percent to 50 percent.

This testimony was very troubling to me because I have the utmost respect for the Secretary, and I have had the privilege of working with him for many years.

A study we commissioned in 1977 by Federated Consultants used an elasticity curve of 2 to 5 percent for spending patterns and predicted a significant loss in business expenditures that would lead directly to a substantial loss of jobs, anywhere from 55,000 to 175,000 throughout the country, a significant portion being members of our union. That study is as valid today as it was 15 years ago.

I believe that other witnesses representing the tourism industry will provide compelling and convincing information that will demonstrate that there has already been economic dislocation within the industry.

As it relates to Treasury's assertion that not one job was lost by reducing the deductibility from 100 to 80 percent, I have to tell you sadly, without attributing any one single factor, that our union, from January 1987 to February 1993, has suffered a loss in membership of approximately 10 to 12 percent, and this percentage of loss is predicated on an average membership throughout the country of between 300,000 and 325,000 members.

Putting it in today's terms, we would be talking about $3.5 billion in lost business revenue, and a reduction of expenditures of this magnitude would directly translate to a job loss of between 50,000 to 160,000.

Our union members are extremely frustrated that somehow the perception has developed that this is an inside-the-beltway for fatcat issue. It is not. It is strictly a jobs issue. When revenue goes down, jobs disappear. It is that simple.

In the last several weeks, I have talked to a number of your colleagues who are gravely concerned about base closings, as prescribed by the Base Closing Commission, and the resultant job loss that these closing would create. Most of the members were able to

enumerate immediately how many boilermakers, steelworkers, steamfitters, pipefitters, and sheetmetal workers would lose their jobs because of the proposed base closings in their districts.

Yet when asked about why I was working and what I was working on, I mentioned the business meal deduction: Oh, total disbelief that the jobs of those who work in the districts' hotels, restaurants, and tourist attractions would be on any endangered list.

Well, to be honest, they said: It is popular perception that it strictly is a fat-cat issue, inside the beltway. Clearly in the minds of many Members of Congress and the administration, it is perfectly okay for the country to pay billions of dollars to defense contractors, as long as it provides jobs and it can be done under the political cover of national defense.

But if you are a waiter, waitress, busboy, bartender, bellhop, et cetera, in this country your job is expendable. Your contribution to the Nation's economy is just not as valuable. Your family and your future is not as important.

However, it is apparent to us how this perception of tourism workers as an expendable commodity arises. One need only listen to the speeches of President William Jefferson Clinton or Secretary of Labor, Robert Reich, to find out that the goal of this administration is to provide 250,000 new jobs. If that is done at the expense of those currently holding jobs, well, that is tough. We will retrain them for a position to be named later.

The President claims that the price is not too high to pay, because these new jobs will be good jobs; that is, they will be high-paying, high-tech, computer-related jobs.

What about urban America, which takes a disproportionate hit on this issue and where the vast number of our membership is located?

Lobbying various Members of Congress for support, it is my understanding that the administration has implied to the members of the different caucuses, including the Black and Hispanic Caucuses, that the loss of these tourism jobs is not important, because they are not, quote, "good jobs". The administration believes that they are jobs that subjugate people to dead-end careers.

So Mr. President, we say—Mr. Chairman, excuse me—with the greatest of respect, I urge this committee to reject this proposal, which would create an undue burden and sacrifice on hundreds of thousands of American families. There are numerous revenue sources you can use to offset the amount credited to this issue by the revenue estimators.

Thank you for your time, attention, and consideration. I will be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF ROBERT E. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL EMPLOYEES & RESTAURANT EMPLOYEES INTERNATIONAL UNION, AFL–CIO

ON BEHALF OF EDWARD T. HANLEY, GENERAL PRESIDENT OF THE HOTEL EMPLOYEES AND RESTAURANT EMPLOYEES INTERNATIONAL UNION AND ALL THE HEREIU MEMBERS WE ARE PRIVILEGED TO REPRESENT, IT IS ONCE AGAIN A PLEASURE TO APPEAR BEFORE THIS DISTINGUISHED COMMITTEE AS IT DELIBERATES ON PRESIDENT CLINTON'S ECONOMIC PACKAGE.

OVER THE YEARS, WE HAVE HAD THE PRIVILEGE OF WORKING WITH CONGRESS, MOST ESPECIALLY WITH THIS DISTINGUISHED COMMITTEE, ON A MYRIAD OF ISSUES. THEREFORE, WE KNOW THE COMMITTEE WILL APPRECIATE THE SPIRIT AND INTENT OF OUR TESTIMONY. EVEN THOUGH THIS UNION AND ITS MEMBERS WORKED TIRELESSLY ACROSS THE COUNTRY ON BEHALF OF THE CLINTON-GORE TICKET, WE CANNOT SUPPORT THE PRESIDENTIAL PACKAGE AS ONE UNIT, BECAUSE THE PACKAGE INCLUDES A PROPOSAL TO REDUCE THE DEDUCTIBILITY OF LEGITIMATE BUSINESS AND ENTERTAINMENT EXPENSES FROM 80 PERCENT TO 50 PERCENT THAT WOULD CREATE A SIGNIFICANT LOSS OF MEMBERSHIP.

SECRETARY OF THE TREASURY LLOYD BENTSEN TESTIFIED RECENTLY BEFORE THIS COMMITTEE THAT THERE WILL NOT BE ONE SINGLE JOB LOST OR ONE LESS PENNY SPENT BY CONSUMERS IF THIS PROPOSAL IS ADOPTED. THE IMPLICATION WAS CLEAR THAT THERE WAS NO EFFECT IN REDUCING THE DEDUCTIBILITY FROM 100% TO 80%, AND THAT THEREFORE THERE WOULD BE NO EFFECT IF YOU REDUCE IT FROM 80% TO 50%. THIS TESTIMONY WAS VERY TROUBLING TO ME BECAUSE I HAVE THE UTMOST RESPECT FOR THE SECRETARY AND I HAVE HAD THE PRIVILEGE OF WORKING WITH HIM FOR MANY YEARS.

A STUDY WE COMMISSIONED IN 1977 BY CONFEDERATED CONSULTANTS PREPARED BY ED UNGER ITS LATE PRESIDENT WAS PREDICATED ON THE CARTER ADMINISTRATION'S PROPOSAL TO REDUCE THE DEDUCTIBILTY OF LEGITIMATE BUSINESS MEAL EXPENSES FROM 100 PER CENT TO 50 PER-CENT. USING AN ELASTICITY CURVE OF 2-5 PERCENT FOR SPENDING PATTERNS, AS WELL AS SOUND ECONOMIC PRINCIPLES, THE EXPERTS PREDICTED A SIGNIFICANT LOSS IN BUSINESS EXPENDITURES SHOULD SUCH A POLICY CHANGE OCCUR. THAT REDUCTION IN EXPENDITURES, IN TURN, WOULD LEAD DIRECTLY TO A SUBSTANTIAL LOSS OF JOBS -- ANYWHERE FROM 55,000-175,000 JOBS <u>THROUGHOUT</u> THE COUNTRY, A SIGNIFICANT PORTION BEING MEMBERS OF OUR UNION. THAT STUDY IS AS VALID TODAY AS IT WAS 15 YEARS AGO.

I BELIEVE THAT OTHER WITNESSES REPRESENTING THE TOURISM INDUSTRY WILL PROVIDE COMPELLING AND CONVINCING INFORMATION THAT WILL DEMONSTRATE THAT THERE HAS ALREADY BEEN ECONOMIC DISLOCATION WITHIN THE INDUSTRY. AS IT RELATES TO THEIR ASSERTION THAT NOT ONE JOB WAS LOST BY REDUCING THE DEDUCTIBILITY FROM 100 PERCENT TO 80%, I HAVE TO TELL YOU SADLY, WITHOUT BLAMING ANY SINGLE FACTOR, THAT OUR UNION, FROM JANUARY 1987 TO FEBRUARY 1993, HAS SUFFERED A LOSS IN MEMBERSHIP OF APPROXIMATELY 10-12 PERCENT. THIS PERCENTAGE OF LOSS IS PREDICATED ON AN AVERAGE MEMBERSHIP THROUGHOUT THE COUNTRY OF BETWEEN 300,000 AND 325,000 MEMBERS.

TO OUR DISMAY, THE FACT THAT THE DEDUCTIBILITY HAS RISEN ONCE AGAIN POINTS OUT THE TOTAL LACK OF UNDERSTANDING OF THE TOURISM INDUSTRY AND THE CONTRIBUTION IT MAKES TO THE NATIONAL ECONOMY OR TO THE LABOR-INTENSIVENESS OF THE INDUSTRY.

THESE THEN ARE THE FACTS WHICH YOU SHOULD BE AWARE OF BEFORE TINKERING WITH WHAT IS PROBABLY THE MOST SUCCESSFUL DOMESTIC INDUSTRY THIS COUNTRY NOW HAS.

IN 1992, $369 <u>BILLION</u> WAS SPENT ON TRAVEL SERVICES ACROSS THE COUNTRY, OF WHICH <u>85 PERCENT</u> REPRESENTED DOMESTIC EXPENDITURES, 15 PERCENT INTERNATIONAL. THAT SPENDING GENERATED NEARLY $44 <u>BILLION</u> IN TAX REVENUES FOR FEDERAL, STATE, AND LOCAL GOVERNMENTS, OF WHICH $24 BILLION GOES TO THE FEDERAL GOVERNMENT. IN OTHER WORDS, FOR EVERY DOLLAR SPENT, 13 CENTS GOES TO SUPPORTS FEDERAL, STATE AND

LOCAL PROGRAMS.

THE ONE BILLION DOLLARS A DAY THAT TRAVELERS SPEND PAYS THE SALARIES OF NEARLY 6 MILLION AMERICANS, MAKING THE TRAVEL INDUSTRY THE SECOND LARGEST EMPLOYER IN THE COUNTRY (EXCEEDED ONLY BY THE HEALTH SERVICES INDUSTRY). MOREOVER, THE TRAVEL INDUSTRY PROVIDES A DISPROPORTIONATE NUMBER OF JOBS FOR THE TRADITIONALLY DISADVANTAGED IN THIS COUNTRY: AFRICAN-AMERICANS (11.5 PERCENT OF TOTAL 1989 TRAVEL INDUSTRY EMPLOYMENT, COMPARED TO 10.2 PERCENT NATIONALLY); HISPANIC-AMERICANS (10.5 PERCENT VERSUS 7.3 PERCENT NATIONWIDE); AND WOMEN (51.5 PERCENT VERSUS 45.2 PERCENT OF TOTAL U.S. EMPLOYMENT).

WHEN YOU HAVE AN INDUSTRY SUCH AS TOURISM THAT GENERATES BY ITSELF SIX PERCENT OF THE NATION'S GNP WITHOUT ANY SIGNIFICANT GOVERNMENT EXPENDITURE, YOU ENCOURAGE GROWTH, NOT DISCOURAGE IT. THE TRAVEL AND TOURISM INDUSTRY IS, AFTER ALL, THE THIRD LARGEST RETAIL INDUSTRY IN TERMS OF BUSINESS RECEIPTS, FOLLOWING ONLY AUTOMOTIVE DEALERS AND FOOD STORES.

EVEN INTERNATIONAL TOURISM IS A PLUS IN THAT IT REPRESENTS THE ONLY EXPORT ACCOUNT THAT SHOWS A SURPLUS. INTERNATIONAL TOURISM IS THE LARGEST U.S. BUSINESS SERVICES EXPORT AND ACCOUNTS FOR 11 PERCENT OF TOTAL U.S. EXPORTS OF GOODS AND SERVICES ($73 BILLION IN 1992 AND 1.3 MILLION U.S. JOBS).

PUTTING IT IN TODAY'S TERMS, WE WOULD BE TALKING ABOUT THREE-AND-A-HALF BILLION DOLLARS IN LOST BUSINESS REVENUE. A REDUCTION OF EXPENDITURES OF THIS MAGNITUDE WOULD DIRECTLY TRANSLATE TO A JOB LOSS OF BETWEEN 50,000-160,000.

OUR UNION MEMBERS ARE EXTREMELY FRUSTRATED THAT SOMEHOW THE PERCEPTION HAS DEVELOPED THAT THIS IS AN "INSIDE-THE-BELTWAY" OR "FAT-CAT" ISSUE. IT IS NOT. IT IS STRICTLY A JOBS ISSUE. WHEN REVENUE GOES DOWN, JOBS DISAPPEAR. IT'S THAT SIMPLE.

IN THE LAST SEVERAL WEEKS, I HAVE TALKED TO A NUMBER OF YOUR COLLEAGUES WHO ARE GRAVELY CONCERNED ABOUT BASE CLOSINGS AS PRESCRIBED BY THE BASE-CLOSING COMMISSION AND THE RESULTANT JOB LOSS THAT THESE CLOSINGS WOULD CREATE. YOU ARE ALL ABLE TO ENUMERATE IMMEDIATELY HOW MANY BOILERMAKERS, STEELWORKERS, STEAMFITTERS, PIPEFITTERS AND SHEETMETAL WORKERS WOULD LOSE THEIR JOBS BECAUSE OF THE PROPOSED BASE CLOSINGS IN YOUR DISTRICTS. YET, MANY EXPRESSED DISBELIEF THAT THE JOBS OF THOSE WHO WORK IN THEIR DISTRICTS' HOTELS, RESTAURANTS, AND TOURIST ATTRACTIONS ARE VERY MUCH ON THE ENDANGERED LIST AS WELL. TO BE HONEST, MANY WERE NOT INTERESTED BECAUSE OF THE POPULAR PERCEPTION THAT IT SIMPLY DEPRIVES "FAT-CATS" OF A FANCY LUNCH.

CLEARLY, IN THE MINDS OF MANY MEMBERS OF CONGRESS AND THE ADMINISTRATION, IT IS PERFECTLY OK FOR THE COUNTRY TO PAY BILLIONS OF DOLLARS TO DEFENSE CONTRACTORS AS LONG AS IT PROVIDES JOBS AND IT CAN BE DONE UNDER THE POLITICAL COVER OF NATIONAL DEFENSE.

BUT IF YOU ARE A WAITER, WAITRESS, BUSBOY, BARTENDER, BELLHOP, RESERVATIONS CLERK, ETC. IN THIS COUNTRY YOUR JOB IS EXPENDABLE. YOUR CONTRIBUTION TO THE NATION'S ECONOMY IS JUST NOT AS VALUABLE. YOUR FAMILY AND FUTURE IS NOT AS IMPORTANT.

HOWEVER, IT IS APPARENT HOW THIS PERCEPTION OF TOURISM INDUSTRY WORKERS AS AN EXPENDABLE COMMODITY ARISES. ONE NEED ONLY LISTEN TO THE SPEECHES OF PRESIDENT WILLIAM JEFFERSO1N CLINTON OR SECRETARY OF LABOR ROBERT REICH TO FIND OUT THAT THE GOAL OF THIS ADMINISTRATION IS TO BE ABLE TO PROVIDE 250,000 NEW JOBS. IF THAT IS DONE AT THE EXPENSE OF THOSE CURRENTLY HOLDING JOBS, WELL THAT'S TOUGH. WE'LL RETRAIN THEM FOR A POSITION TO BE NAMED LATER.

THE PRESIDENT CLAIMS THAT THAT PRICE IS NOT TOO HIGH TO PAY

BECAUSE THESE NEW JOBS WILL BE "GOOD" JOBS. THAT IS, THEY WILL BE HIGH-PAYING, HIGH-TECH, COMPUTER-RELATED JOBS.

IN NUMEROUS SPEECHES THAT PRESIDENT CLINTON AND LABOR SECRETARY REICH HAVE MADE, THEY HAVE CONSISTENTLY REFERRED TO A FOUR-YEAR COLLEGE EDUCATION AS EVERYONE'S GOAL. THERE IS NEVER A MENTION OF TECHNICAL OR VOCATIONAL SCHOOLS. APPARENTLY THIS OMISSION IS BY DESIGN -- NOT BY ACCIDENT.

IN LOBBYING VARIOUS MEMBERS OF CONGRESS FOR SUPPORT, IT IS MY UNDERSTANDING THAT THE ADMINISTRATION HAS TOLD MEMBERS OF THE BLACK AND HISPANIC CAUCUSES, AMONG OTHERS, THAT THE LOSS OF THESE TOURISM JOBS IS NOT IMPORTANT BECAUSE THEY ARE NOT "GOOD" JOBS. THE ADMINISTRATION BELIEVES THEY ARE JOBS THAT "SUBJUGATE" PEOPLE TO "DEAD-END CAREERS".

THE JESUITS AND THE FOLKS ON THE WEST SIDE OF CHICAGO WHERE I AM FROM, WOULD EITHER REFER TO THIS ATTITUDE AS ELITISM OR INTELLECTUAL ARROGANCE. BY WHATEVER TERM, IT IS AN ATTITUDE OF INCREDIBLE IGNORANCE AND CONDESCENSION TOWARD GENERATIONS OF AMERICANS WHO HAVE MADE THEIR WAY HONESTLY, UP-THROUGH-THE-RANKS.

ON BEHALF OF GENERAL PRESIDENT HANLEY, I WANT TO LET THIS COMMITTEE AND ALL THE MEMBERS OF CONGRESS KNOW HOW TERRIBLY PROUD WE ARE TO HAVE THE PRIVILEGE OF REPRESENTING THESE HARD-WORKING, DEDICATED PROFESSIONALS, MANY OF WHOM HAVE RAISED KIDS THAT DID INDEED GO ON TO ATTEND A FOUR-YEAR COLLEGE. I DOUBT THAT THEIR CHILDREN ACCORD THEIR OWN "GOOD" JOBS ANY MORE RESPECT THAN THEIR PARENTS' JOBS -- THE JOBS THAT PUT THEM THROUGH SCHOOL.

BUT, THEN AGAIN, WE DO NOT REPRESENT POLICY WONKS, SO THAT MIGHT EXPLAIN THE INDIFFERENCE TOWARDS THOSE WHO ARE MEMBERS OF OUR INDUSTRY AND OF OUR UNION.

WHILE STANDING ON THE FLOOR OF MADISON SQUARE GARDEN LAST JULY, I WAS ESPECIALLY STRUCK BY THE WORDS OF THEN CANDIDATE, WILLIAM JEFFERSON CLINTON, WHO SAID: I ACCEPT THIS NOMINATION ON BEHALF OF THE AVERAGE AMERICAN, THE GOOD DECENT, HARDWORKING PEOPLE WHO RAISE THEIR FAMILIES AND PAY THEIR TAXES AND WHOSE VOICES HAVE NOT BEEN HEARD. CANDIDATE CLINTON TOLD THE COUNTRY THEN HE WAS RUNNING SO THAT THESE PEOPLE WOULD SHARE IN THE AMERICAN DREAM.

SO, MR. PRESIDENT, WE SAY WITH THE UTMOST SINCERITY THAT WE HAVE HEEDED YOUR CLARION CALL. THIS UNION DOES REPRESENT SUCH AMERICANS, AND WE SPEAK FOR THEIR INTERESTS, AND THEIR VOICES WILL BE HEARD. BUT WHEN EXACTLY DID YOU DECIDE THAT THE MILLIONS OF PEOPLE EMPLOYED IN THE TOURISM INDUSTRY WERE EXCLUDED FROM THAT DREAM?

WITH THE GREATEST OF RESPECT, I URGE THIS COMMITTEE TO REJECT THIS PROPOSAL WHICH WOULD CREATE AN UNDUE BURDEN AND SACRIFICE ON HUNDREDS OF THOUSANDS OF AMERICAN FAMILIES. THERE ARE NUMEROUS REVENUE SOURCES YOU CAN USE TO OFFSET THE AMOUNT CREDITED TO THIS ISSUE BY THE REVENUE ESTIMATORS. WE HOPE THAT AN AMELIORATION CAN BE REACHED ON THIS ISSUE WITH AN ENLIGHTENED CONGRESS, AND THEN WE CAN ROLL UP OUR SLEEVES AND HELP GET THE NECESSARY VOTES NEEDED TO PASS AN ECONOMIC PACKAGE THAT WILL TRULY HELP A NATION WHICH IS IN MUCH DISREPAIR AND TRULY IN NEED OF A LEGITIMATE MORALE BOOST.

THANK YOU FOR YOUR TIME, ATTENTION, AND CONSIDERATION. I'LL BE HAPPY TO ANSWER ANY QUESTIONS YOU MAY HAVE.

Mr. RANGEL. Thank you, Mr. Juliano.

Mr. Brewster.

Mr. BREWSTER. Thank you, Mr. Chairman.

Gentlemen, I certainly appreciate your testimony. Let me see if I have got this right now. All of your industries are going to be subject to the rest of the tax parts of it, to the income tax increase, the Btu tax or whatever.

But you are also telling us that the reduction in the 80-percent deductibility to 50 percent would decrease your customer base.

Mr. LEFFLER. That is right.

Mr. BREWSTER. So you, in essence, get a double hit. Is that what I am being told?

Mr. LEFFLER. It is counterproductive, totally counterproductive.

Mr. BREWSTER. OK. And, Mr. Berman——

Mr. BERMAN. Yes, sir.

Mr. BREWSTER [continuing]. I think you made some very good points considering the type of business you run. A $5.25 cheeseburger in DC would be a $2.75 cheeseburger in my district. [Laughter.]

Mr. BERMAN. Yes, sir.

Mr. BREWSTER. But in rural Oklahoma, small business owners do utilize a lot of their business deductions, and that is the most advertising they can do.

Mr. BERMAN. That is correct.

Mr. BREWSTER. Do you see that as a nationwide situation?

Mr. BERMAN. When I represent myself here, I can talk in terms of my business. I am midsized. I have 110 seats. I employ 30 people. I can tell you candidly that in my store, based on my own experience, that this measure will reduce my sales. If it reduces my sales, there will be a consequent not only reduction in revenue at the Federal, State, and local levels, but I am also going to have to take a close look at my labor cost. It is all I have left. There is nothing else that I can tinker with.

And these people are my family. You have to understand, in our industry, we are very close. We employ more than 9 million people in food service in this country. It is projected to go to 12 million by the year 2005.

What we need now is to be nurtured by Government. We can survive now. But any more hits, after the last 3 or 4 years, the choices that I have to make are going to be very, very difficult.

Mr. BREWSTER. And, Mr. Wachtel, I find it interesting that theater is here today, especially since this is the 50th anniversary of the play, "Oklahoma," opening on Broadway. [Laughter.]

Which some of us from Oklahoma are pretty proud of and believe it to have been a major contribution to the arts of this country.

But you mentioned that this would result, in your opinion, in a 6-percent loss. Can you define that in the approximate number of jobs we are talking about, in a fairly short answer, because I have another question or two?

Mr. WACHTEL. Well, that would be difficult for me to come up with a number on the spot. I know that about a third of the shows running on Broadway at this time would probably be forced to close, and that the typical musical employs over 100 people, plus other supportive industries, so we are talking about 1,000 jobs

there, plus we are talking about probably twice as many jobs in the industries that support those shows. And that is just New York, which is a very small minority of the total theater attendance. If shows do not succeed in New York, then shows do not tour.

I can only tell you that the total number of jobs generated by the theater and performing arts industry nationally is estimated at about 135,000, and that would take a significant hit.

Mr. BREWSTER. Mr. Juliano, you and I have discussed before that international tourism is one of the few bright spots in America today, as far as balance of trade.

Mr. JULIANO. Correct.

Mr. BREWSTER. And that this Nation enjoys about a $16 billion surplus in trade there. And the last 4 years are really the first time we have had a plus.

But you are talking about the number of people that are in your union organization that would lose their jobs if this deductibility changed from 80 to 50.

Would it be safe to say that those people would have a difficult time getting another job, or are they—while they are very skilled at what they do now, would they be considered fairly low-skilled workers for other types of jobs?

Mr. JULIANO. It would be very difficult if you deemphasize the tourism industry for them to be relocated. Plus the other factor, Congressman, is, once they are on unemployment, you are shifting them from being a productive taxpaying citizen to someone who is getting money from the Federal Government.

But if you are going to decrease the scope of the industry, which this proposal would do, you are going to decrease the job base. It is that simple.

Mr. BREWSTER. OK.

Mr. JULIANO. And we would lose probably another 30,000 to 35,000 members.

Mr. BREWSTER. 30,000 to 35,000?

Mr. JULIANO. Just our union.

Mr. BREWSTER. Thank you, Mr. Juliano.

Thank you, Mr. Chairman.

Mr. RANGEL. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I appreciate the quality of the testimony of this panel, and that is from one who has supported reducing the deduction for business meals and so on. And I guess the message I hear from you is, this is absolutely no time to be making such tax changes, that you are far too fragile out there.

I think the connection you made, Mr. Wachtel, with the cities—this is one of the few businesses that still is going on in the cities. It is a very sobering comment.

And as one who voted just yesterday to save $12.8 million—now it is not a lot, but those are the building blocks of doing this through cutting spending, and I would really hope that this committee would not feel obliged to meet the deficit reduction targets entirely through the revenue package that the President has proposed, but being willing to refer on to other committees funding cuts that we will support, just as other committees refer to us bills that involve new revenues.

But I do think it is important for this committee to be able to say: At this time, we cannot take this amount of money out. I think your testimony helps to bring that home, that there is no margin out there. And I know in Connecticut, which has been very hard hit by the recession, there is just no margin out there.

And, Mr. Berman, your comments that if the Btu, the increase in Medicare tax, and the other things in this package that will increase your costs, and you have no control over it, followed by an increase in the minimum wage which the Secretary of Labor is talking about and an increase in other taxes to fund health care, that you are not going to be there next year.

And I think we have got to sober up about that and look at the fact that we are going to increase spending more than we are going to cut spending in this package, and we have got to reverse that. If we reverse that, we can do some changes on the revenue side that will help us out, but we will not devastate small business.

And that is the message that I hear from you, and I have no questions.

Thank you.

Mr. RANGEL. Thank you.

Mr. Payne.

Mr. PAYNE. No questions, Mr. Chairman, just a comment. And that is, I would like to thank all of you for your testimony today. As someone who has been in the industry that you are in, having operated restaurants and a hotel before coming to Congress, I do understand your testimony and share your concerns, and I was where you were in the 1986 Tax Act.

So thank you very much for being here, and you have done us a great service.

Thank you.

Mr. RANGEL. Mr. Santorum.

Mr. SANTORUM. I would just like to say ditto to Mr. Payne's comments, except that I just eat in restaurants; I never ran one. But you made some excellent comments, and I will certainly be supportive of trying to help you out.

Thank you.

Mr. RANGEL. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Tourism is a very important industry to Oregon and especially my district.

Previous panels said that as tax policy we should not favor one industry over another in our Tax Code, and some may argue that this is favorable treatment to the restaurant industry in particular here.

I guess, what do I say to my folks back home, if I have a couple of millworkers who sit around the lunchroom, and they take their lunch sack and lunchbox to work, and they sit around on their lunchtime, and they talk about how the mill is operating and a particular problem with the machinery, they do not get to deduct that cost of their lunch, but if they go down to the local restaurant and eat their lunch, they do get—they could deduct that—what do I say to those folks in terms of tax fairness, tax policy?

Mr. BERMAN. I would just say off the cuff, when they are eating their brown-bag lunch, if they are conducting business, it should probably be deductible.

Mr. KOPETSKI. All right.

Mr. BERMAN. But coming to my business, conducting business, the people that come into my business are sales reps, they're developers, they're contractors. They are doing business. This is——

Mr. KOPETSKI. I am not arguing that. I am arguing the fact that——

Mr. BERMAN. I do not know. I honestly then cannot answer your questions. I cannot tell you what to tell them.

Mr. KOPETSKI. Well, let us ask Mr. Juliano. Maybe he has an answer.

Mr. JULIANO. I think, Congressman, that the answer is, we understand and share their concern and their plight, but their neighbors are probably employed as a result of the hotel and restaurant industry. And so it affects the whole community. I mean, they have—they cannot conduct——

Mr. KOPETSKI. So they can subsidize those other workers? That is what I should tell them?

Mr. JULIANO. No, no.

Mr. KOPETSKI. In their jobs.

Mr. JULIANO. If people are off of work, the ripple economic effect of our industry is extensive, and the money stays within the local economy. If you have tourists coming to your city and your State, the money stays there; the tax dollars are spent there; those people who are our members and others in the industry work there. They go back to their community; they spend money at the retail store, at the pharmacy, et cetera, et cetera. So it is a whole impact on the overall community.

Mr. KOPETSKI. OK. So that is what I am going to tell my——

Mr. LEFFLER. Congressman, could I take a shot at that?

Mr. KOPETSKI. Yes, absolutely.

Mr. LEFFLER. All taxpayers have different things with which they have to cope. Our people are all independent sales representatives. They employ other salespeople to work for them. But they have to pay all of their own expenses, and because the nature of their business is either a partnership or an individual proprietorship or a subchapter S corporation, they do not get to deduct the cost of their health insurance.

But the fellows you are talking about in the mill eating lunch, they get to have their health insurance paid for as things stand now, because it is a corporate deduction.

So it is just as necessary——

Mr. KOPETSKI. If they have health——

Mr. LEFFLER. Yes, of course.

Mr. KOPETSKI. A lot of people do not.

Mr. LEFFLER. I have to talk on a broad base. So that that is——

Mr. KOPETSKI. That is pretty good actually. I will remember that.

Let me ask you this other question now. We have to make some tough choices here, as you all know, in terms of who to tax, who not to tax.

What are your priorities in this in terms of, if we have to keep an extra part of the proposed corporate tax increase in order to

maintain the deductibility at its current level, would that be preferential to you?

Let us say we eliminate the temporary investment tax credit, and we have got some savings there. Well, the question becomes: Do we lower the corporate, proposed corporate rate, or do we spend that money and restore the deductibility to its current level? Which is your preference that we do as a committee? It is either/or.

Mr. LEFFLER. Well, I do not know that—I mean, you are framing it as either/or, but I am not sure that it is either/or. In other words——

Mr. KOPETSKI. Well, it gets down to that.

Mr. LEFFLER. In other words, what is unfair to one does not mean that it is fair to the other to do the opposite.

Mr. HARTLEY-LEONARD. Congressman, if I might be so bold as to interrupt, I think that what we are here to appeal to you to consider is not whether or not you have to raise taxes.

I think one understands the condition that the country is in, and one understands that revenues must be increased, though, of course, the population that you represent beseech you all to reduce expenses.

What we are saying is that this tax, as presently considered, is discriminatory. If you were to come back and say, we need to raise more revenues for this country because the country has got itself in an economic crisis, and we must build a foundation over the next 10 to 20 years in order to cure the ills that we have created over the last 40 years, any good-sense, loyal American applauds that and understands it, probably no matter the educational level of the person you are communicating with.

If you were to say, we have to consider raising more revenues by consideration of such things as a VAT tax, providing that you take into consideration the problems of the poor and the disadvantages with regard to food, medicine, issues like that, I think you would find a more understanding environment.

But when you say, we are going to tax the issue of one particular segment of business, that the fuel required to feed the business traveler is taxed differently than the fuel required to drive the truck, one argues that—you have to take into consideration the downstream effect on jobs by doing that. And I think that that is what we are all trying here today to communicate.

This is a jobs issue. This is a jobs issue as it relates to a very, very delicate industry that is in crisis, whether it be the restaurant industry, the hotel industry, the entertainment industry. These are industries in crisis.

Mr. KOPETSKI. Well, we are out of time, unfortunately. And I appreciate all of your testimony. I thought it was very good—Mr. Chairman, just 30 more seconds, if I can be indulged here—that we do get down to these either/or questions.

And we are looking at a VAT and some other things, but, you know, it is going to get down to what do we do in this kind of situation.

And what I think you are saying is: Make it fair. Put any kind of tax increase across the board. Do not nickel and dime us or nickel and dime our industry.

Mr. HARTLEY-LEONARD. I think that that is accurate, Congressman.

Mr. KOPETSKI. Thank you.

Mr. RANGEL. Mr. Hartley-Leonard, I do not know whether you help your argument by talking about it as discriminatory against an industry. And you used an example before with the luxury boats, how we taxed ourselves out of jobs.

It would have one to believe that that is the epitome of the trickle-down theory that we are dealing with, and I know you do not mean to project that image.

I do not think there is any question that by restricting the conduct of people as they have not hamburger accounts, but unlimited business accounts, that one is not inclined to be more extravagant when personally they know that a part of that bill is going to be shared with the taxpayer. That is human nature.

And because someone is making up the bed and cleaning the toilets and bringing the food to the room, sure, they have jobs. But, we ought to take into consideration; I am here to protect those jobs, because they are important to people and always have been, as we look forward to upward mobility in this great Republic. But, you know, whether or not those boat people are making boats because of the tax, or they are not making boats because of the recession, or maybe we were wrong in taxing them, we knew exactly what we were doing. We may not have gotten the right result, but we cannot have a country where people can just lavishly live and explain it away, that as they do this thing, someone is crushing the grapes and canning the caviar.

Mr. HARTLEY-LEONARD. My experience, Congressman, is—and I have been in this business some 29 years and have run this particular company for some 7 years—my experience is that the three-martini lunch has during my tenure of running a corporation always been a myth.

There are certain ways accepted worldwide of creating business and doing business. I would argue, sir, that entertaining potential customers in order to create psychic income for that potential customer has a marked impact on the decision of the person who is being entertained as to whether or not they buy your product.

After all, when it all gets down to it, people continue to do business with people they like. And American business has, over time, been done on the basis of personal relationships. And the entertaining of your potential customer enhances that personal relationship.

I have not been witness—and I would argue that I am in the high end of the lodging industry—I have not seriously been witness to excess on the part of corporations. After all, it still has an impact on the profit of that company. And I can assure you that I have a travel budget in excess of $3 million for my own company. That is not a travel budget that I will expand; that is a travel budget that I watch diligently over everyone that travels. Expense accounts are looked at most diligently to make sure that, from a profit point of view of our corporation, we are not allowing employees to excessively entertain.

Mr. RANGEL. Mr. Hartley-Leonard, you are saying that if we do not allow the deduction, that business people will forfeit the opportunity to create this friendly climate where they can enhance their

profits, that they will decide that they cannot afford to do this in order to create business.

Mr. HARTLEY-LEONARD. Not at all, sir. What I am saying is that, given the economic climate that we are existing in at this time, which I am sure all of you are aware is not robust and healthy, profits are limited for a vast number of corporations, and that the deductibility issue is a profit issue for those corporations.

I mentioned to you the issue of restaurants within my own company. Fifty percent of the restaurants that I am operating, some 220 restaurants, are at this point at break-even or perhaps at a loss, on a fully allocated basis.

Mr. RANGEL. I will accept that argument. But you are not saying that when things improve that we should take another look at this. But I will accept that argument.

Mr. HARTLEY-LEONARD. No, I am not saying that.

Mr. RANGEL. This would hardly be the time to do that.

Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

I want to talk about trickle-down taxation for a minute, whether it is Btu taxes or whatever else. And I would say to my friend, again—he was out of the room earlier—from Oregon that there is a choice we have. We do not have to say who we are going to tax. We can vote down the budget package and do what I think most of my constituents want, and that is to cut some spending and not raise taxes.

And so why should we be arguing about which tax we are going to raise, when, in fact, what we ought to be doing is figuring out how we can get the economy going?

And whether you buy the luxury tax question or not, the fact is, it did close down an industry. The fact is, some people lost their jobs as a result of it. I think you can quantify in the restaurant business, the entertainment business, that x number of people will lose their jobs if certain tax decisions are made.

The Tax Code is not always consistent and fair. In my State, for instance, we do not have a State income tax. I do not think we need one. But we are treated unfairly in that sales tax is not deductible from the Federal tax returns. Income tax is. The Tax Code is replete with inconsistencies that are put there for a particular purpose.

Now, Mr. Berman, I compliment you on your testimony, and I have a question that is separate from some of the things that have been discussed.

I have been concerned with the FICA problem that we have in this country, and I have joined with my colleague—who is not here right now, but I want to compliment him—Mike Andrews, on the legislation that would provide an income tax credit for the amount of FICA taxes paid in excess of the minimum wage. What this will do is address an inconsistency in the law which occurred due to a tax change in the 1987 Budget Reconciliation Act.

I believe the current FICA payroll tax on tips is unfair and has hurt the food service industry in terms of profitability. Mr. Berman, I would like to know what your personal experience is with the FICA tax on tips problem?

Mr. BERMAN. Personally, in my store, the FICA tax on tips costs me about $5,800 a year off my bottom line. This is a payroll tax that is levied on nonpayroll tax dollars, and it has been extended now by the IRS. If you are audited a few years down the road and it is found that your employees have underdeclared their tips, you are also, at that time, levied by the IRS for the FICA on the undeclared amount of your tips. So we face both a hit in terms of a payroll tax on nonpayroll tax dollars and then down the road the potential, if an audit occurs, for nondeclarations by our employees over which we have absolutely no control.

So we did support H.R. 11 last year, that then-President Bush vetoed, and we do support that kind of legislation now, and that would be tremendously helpful to our industry.

Mr. SUNDQUIST. My second question: Over 70 percent of restaurants are small businesses with gross annual sales below $500,000, and profit margins—I do not know what it is in cheeseburgers, but it is about——

Mr. BERMAN. Four percent.

Mr. SUNDQUIST. In your opinion, have some restaurants gone out of business due to the fact of the payroll tax on tip income?

Mr. BERMAN. I am the president of an association in Montgomery County. I do not know that you could say it is any one particular thing. But I can tell you that the turnover rate in the State of Maryland from 1990 to 1991 was—there was a 106.5 percent increase in the number of closures in my State during that time period.

Was it just FICA tax on tips, no. Is it the entire environment, operating environment, that we have to deal with, I would say, yes, candidly.

Mr. SUNDQUIST. And a lot of jobs are going to be lost for that and other reasons that we have discussed.

Mr. BERMAN. In particular, these are the kind of jobs that the administration is talking about providing. We have two components to our industry. One is the people who work the floor, who are going on perhaps to other careers, who are going to law school. How many aides supplement their incomes waiting tables?

The other more sensitive group of people are the people like Suzetta and Brenda. These are single mothers; 59 percent of the employees in my industry are women. They are single parents. They have two children. They depend on me to provide for them security and perhaps a long-term future. I think in those terms myself.

Mr. RANGEL. And are not some of the jobs we are talking about creating, the administration is talking about creating, summer jobs across the country? Are not some of those jobs the same jobs that are being destroyed by the tax policy relevant to the——

Mr. BERMAN. As you do things like raise the minimum wage and, of course, the indexes like unemployment, State unemployment, workmen's compensation policies and other things inflate the cost of those wages. You, as an employer, tend to look at more mature people because the dollar cost is that much more. So there is a tendency to not employ younger people.

We in the hospitality industry serve a lot of the functions that the administration is talking about serving. We employ young peo-

ple. We employ people who are disadvantaged. We give them an opportunity to earn both a salary and to pursue other opportunities at the same time without having to draw Government assistance.

Mr. SUNDQUIST. Thank you very much.

Thank you, Mr. Chairman.

Mr. RANGEL. Do you use the targeted jobs tax credit?

Mr. BERMAN. I attended a seminar 2 weeks ago on the targeted jobs credit, and I understand that it is up for renewal.

Somebody mentioned before paperwork and regulations. It is extraordinarily difficult for me to keep up on everything. I have been working 4 years at the State and local level to find out more about what affects my business.

But to answer your question, if you reinstate it, we will absolutely sign up for it. I do have the literature on my desk at home.

Mr. RANGEL. Mr. Jefferson.

Mr. JEFFERSON. Thank you, Mr. Chairman.

I want to commend the entire panel on what I think has been a good job of recharacterizing this debate from one of this being an elitism issue to one where ordinary people are affected by it, and I think that is where this debate belongs, and I am glad to see that you are bringing it to this committee in that fashion and to the Nation.

I want to say to you that I have a certain kinship with the views you have expressed. I have expressed along the way as I have had an opportunity to.

But I am afraid that there are many who are unconvinced about the dangers that you have expressed here, imposing this new requirement in the tax laws. When we talk about the effect of it or the feared effect of it, we are told: Prove it. Show us that this really will happen.

In the testimony that Mr. Leonard gave, he offered something which sounds like proof, in the hard sense that I think these discussions are requiring. You referred in your discussion on page 2 to a study done by Professor Hiemstra, I believe, of Purdue University's Hotel School. And you talk about how he isolated the effect of the 1986 tax increase, in effect, and then was able to attribute the drop in sales to the tax increase.

What I want to know is, did you use his model or extend his model to measure the effect of the proposals by the President on the deductibility of entertainment and business meals, or how did you arrive at your 165,000 job total figure here that you project as lost to the industry?

Mr. HARTLEY-LEONARD. The 165,000 number is the number that comes from the National Restaurant Association, its estimation. It is more familiar with the calculations than I am. I am not able to adequately discuss that issue.

What I am able to adequately discuss, Congressman, is the impact on our company of the 1986 tax hit to the deductibility issue, going from 100 percent to 80 percent. It was at that time that a company even as small as ours went into an across-the-board—restaurant shutdown—when I say "across the board", I mean a vast number of our restaurants being closed at lunchtime, because we clearly saw a dramatic decline in lunchtime entertainment activity.

That, in theory, keeps the restaurant open. But at lunch, shifts are split always, and you have morning crews and evening crews, while that kept the kitchen crews to some extent working, it certainly put off the wait people.

And I would concur with what the gentleman on my left discusses. These are people—I mean, I am fascinated by the job stimulus program, because the jobs that we create and the people that we employ, I would have you understand are to a great extent hard to employ in the near term in other industries.

There are various numbers bandied around with regard to the illiteracy rate in the United States, and I have heard numbers, everything up from 15 percent to 20 percent to 25 percent, and my experience, particularly in the areas of heavy minority employment, which a company such as ours does, I would concur that those numbers are correct. These are not people that can be quickly changed. Over time, with a renewal of our commitment to the educational system in the United States, we will evolve out of this crisis to have people who are functionally literate enough to get these wonderful new jobs that the Government is going to create over time.

But in the meantime, I would ask that we err on the side of caution in not throwing out the baby with the bath water. Truly these are people that might become wards of the State. These are people who cannot get many jobs.

We do run educational programs, writing skills, reading skills. You would be amazed at the number of people in the minimum wage category that work in the restaurant and the hospitality industry who are functionally illiterate. It would boggle your mind. These are not people who are going to go and work in the computer industry. These are people who are often part-time employees.

Why just this week we received a call from the White House, asking would we participate in a program, a jobs program, for the summer for teenagers in the inner-city programs. And the suggestion came that those jobs would be in the area of bus help, waiters, kitchen help, dishwashers.

And yet at the same time, what we beseech you to understand is that this type of legislation will eliminate those very jobs that on the one hand the Administration that this particular week to my company alone said were important to the country this coming year.

Mr. JEFFERSON. Thank you.

Mr. RANGEL. The time of the gentleman has expired.

Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

Comments have been made during this hearing paralleling this with the luxury tax on boats. I would like to point out one very big distinction, and hopefully a difference, that will prevent this tax from becoming a reality.

That tax, that ill-thought-out tax, was not a product of this committee. It did not go through the hearing process. We did not hear from people such as you gentlemen on what it was going to do for jobs. We only heard a perception out there that this was a tax on the fat-cat who goes up and down the waterways of this country,

drinking martinis, thumbing his nose at the rest of this country, and by God, we should tax them.

You know, Chairman Rangel, you have brought out, I think, a very good point a few minutes ago. Yes, it is human nature to be a little more lavish in your entertainment if it is a deductible item, if it is a legitimate business expense.

But the same argument can be made that an executive will buy a little better executive chair for his office, and he will furnish his office a little better. He will buy a little better automobile, because it is a legitimate business expense.

We put on the businessmen of this country some very, very tight restrictions as to what is deductible and what is not. I think what this committee ought to do is to go back and say if it is a legitimate business expense, it should be 100 percent deductible.

And it is the most empty-headed argument that I have ever heard that anybody can say that a modest impact from disallowing 20 percent of this deduction proves that disallowing 50 percent of it will not drop business off.

Now traditionally in this country, as long as I can remember, legitimate business expenses for entertainment were deductible. For us to come back and say half of it is not, we are really messing around with something that we have no business messing around with, particularly at a time when we are talking about creating jobs and stimulating this economy.

Now I represent an area—which you can see why I feel so strongly about this—which is up at North Palm Beach, coming down, picking up the Breakers Hotel, continuing on down south through Fort Lauderdale and ending up down at—including the Jackie Gleason Theater on Miami Beach and the Fontainebleau Hotel. Now you think I am not worried about losing this type of deduction because of the jobs it will lose in my district?

I think the only area that could possibly be more injured by this type of action would be Chairman Rangel's district in New York.

These are very important deductions. I think this committee should not look at this and say: Geez, you know, why should anybody deduct something like this or deduct something while they are having a good time? A lot of people have a good time writing a brief in a law office. Just because somebody is going to be enjoying something does not mean that we should disallow it in any way if it is a legitimate business expense.

Anyone who is involved in this type of business knows, if you get too lavish with it, you are going to invite an audit. People are very cautious about what they write off. I would venture a guess that people who have a lot of these type of expenses do not write off a lot of them because they are concerned about triggering an audit and certainly do not want to do it.

I think that what this committee should do is to look and be sure that these are legitimate business expenses. But just because some people are having a good time, just because the hospitality interest is out there we should not limit deductions. It is a very important industry in this country and tourism and everything else is not only important as to the jobs it creates in this country, but it helps with our balance of trade.

We are finding that people, because of the value of the dollar being off, are coming in from other countries. It is a very important industry for this entire country, and I think it would be a terrible mistake for this committee to look at it and say: Hey, somebody may be getting a better meal because of it, and because of that, we need to wipe out an industry and wipe out all these jobs. It would be a terrible mistake.

Mr. Chairman, I would certainly hope that this is a vote that we, as Democrats and Republicans, can get together on and say: This one was not thought out quite right. We have had hearings on it. We know that it is going to be a loss of jobs. We know it is going to hurt parts of this country. And during a time where we are looking to stimulate the economy, we do not want to pass laws that are going to do great damage to a great industry in this country.

Thank you, Mr. Chairman.

Mr. RANGEL. Thank you.

I share the gentleman's concern. During a time of economic recession and loss of jobs, all of us have to be concerned with industries that are really on a fragile operating basis, that we not do anything to push them over the side. This is especially true of the major cities that have lost their tax base, that are relying heavily on tourism, on theater, on entertainment, on the hotel industry.

So the entire committee wants to thank this panel for its very thoughtful testimony.

The chair now recognizes the gentleman from Georgia for the purpose of calling the next panel.

Mr. LEWIS [presiding]. Thank you very much, Mr. Chairman.

Will the next panel come forth: Mr. Hurley, Mr. Collie, Rear Admiral Cooney, Mr. Losey.

[Pause.]

Mr. LEWIS. Let me thank each of you for being here today. The Chair would ask that you be brief in your statement. Your prepared statement will be submitted for the record. When you see the red light appear, the red light indicates stop. It means just stop, so we can continue to move this hearing with dispatch.

Mr. Hurley.

STATEMENT OF GERARD F. HURLEY, EXECUTIVE VICE PRESIDENT, NATIONAL CLUB ASSOCIATION

Mr. HURLEY. Mr. Chairman, my name is Gerard F. Hurley. I am the executive vice president of the National Club Association, which represents over 1,000 social, recreational, and athletic clubs.

Thank you for the opportunity to express our opposition to the reduction or disallowance of business development expenses and club dues deductions.

For many employers and self-employed, face-to-face business development activity is the most cost-effective technique versus high-cost advertising, for example, for building a business, creating jobs, and generating a net taxable profit. The same is true for receptions and pressing the flesh and fund-raising, a favored technique that works.

Sixty-four percent of our members tell us loss of deductibility would have a negative impact on their operations. City clubs and their members and their employees would be hit the hardest.

We are facing the potential loss of 68,000 to 78,000 full-time jobs, mostly service and entry-level jobs, as you have heard earlier, and $140 million a year in employer taxes, without considering potential loss of $63 million in employer taxes on part-time employees potentially lost versus the $200 million-plus in taxes that the disallowance of club dues is supposed to generate in each of the next 5 years.

By making business development techniques even more expensive, particularly for small employers and middle-income employees, increasingly women and minorities, clubs will be used less frequently, thereby pushing some clubs on the margin, over the edge, or returning others more to the domain with those of larger budgets or higher incomes.

Business development entertaining or relationship marketing means real investment, risk, setting the scene, developing a climate of trust and the potential for reward. No climate, no trust; no deal, no jobs. If the activity does not generate a profit, taxpayers do not do it, as the panelists earlier so eloquently said.

Dues represent prepayment for access to a facility and should be as deductible as those charges at a restaurant or a hotel meeting room. That is, overhead costs are already built into the cost of a restaurant meal or a hotel meeting room charge.

Dues are not deductible per se, but must meet a higher primary use test. Would it not seem odd if one could not charge against earnings the documented business development portion of one's dues, yet be able to deduct all of the Goodyear Blimp?

For the employer or self-employed, the drop from 80 to 50 percent of business meals' deductibility could mean effectively a 13-percent increase in his or her net cost.

We read that this allowance or reduction is needed because there is potential for abuse. If there is abuse, enforcement tools are in place.

Two, there is a perception of personal enjoyment. This is pitting one taxpayer against another. Relationship marketing extends the workday and can be as taxing, if you will excuse the pun, as any other activity. The host, after all, is trying to sell a product or service. Were there an attempt to identify expenses perceived to be tied to enjoyment or pleasure, one could start with commodious offices or fine art, as we see in offices in this city, one's picture in company ads, air and rail and shipboard travel, ornamental horticulture for headquarters and so forth.

Virtually every business expense could be challenged on some or other basis as being thought not productive or cost-effective.

The club community, as a major employer and provider of services, is ready to dig deeper, if necessary. If this country needs more revenue, all industries and employer deductible expenses should be called to shave a fraction.

Should employer/employee users of business marketing and employees who earn their living therefrom be asked to shoulder a disproportionate burden?

We believe in a strong economy and in investing in the future. The club community and its employees are a part of that future. However, the economy will be hampered as the Government tries to manage the marketing of certain products and services, favor

some and punishes others, effectively increases the investment required to go to market, and decreases the potential for reward.

Government should increase its revenues by encouraging businesses to raise their net profit, not by reducing the take-home of the employer/employee taxpayer.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

STATEMENT OF THE NATIONAL CLUB ASSOCIATION

INTRODUCTION

The National Club Association submits these comments on the Administration's proposed changes to the tax deductibility of club dues, business meals, and entertaining. We thank the members of the Ways and Means Committee for the opportunity to appear today and offer testimony on this issue so important to the club and hospitality community.

The National Club Association (NCA) is the trade association representing the legal, legislative and business interests of private social, recreational and athletic clubs. Over 1,000 such clubs throughout the country, with an estimated one million members, belong to NCA. Member organizations include country, golf, city, yacht, tennis and athletic clubs. The scope of these club operations range from small clubs with limited membership and facilities to larger, full-scale operations with dining and extensive recreational facilities. Some of these facilities are operated on a seasonal basis while many are open year round.

The private club community has nearly 7,000 clubs which employ over 450,000 full-time and 220,000 part-time personnel. Nearly all clubs have food and beverage service. Our most recent survey shows food and beverage revenues to be over $13.6 billion annually. For example, nearly 50 percent of city club revenue comes from food and beverage purchases.

THE PROPOSALS WILL HAMPER THE ECONOMIC STIMULUS PACKAGE

The economic plan of the Administration, touted as a stimulus package, is relying on both spending and tax incentives to build the economy and create jobs. If, however, the deduction for club dues is repealed and business-meals and entertaining deductibility is reduced to 50 percent, the financial impact on club employees, mid-level executives, club members, and the economy will be just the opposite.

Many small businesses invest in business-development entertaining as a more effective means of generating business than other options, such as high-cost advertising which few employers can afford. Expense and dues deductions merely reflect the investment businesses make to conduct business and thereby generate taxable net income.

Changes to the tax deductibility of club dues, business meals, and entertaining will be a blow to the club community, still feeling the effects of a slow economy. For example, in a letter to Congress last year, a manager from a Midwest country club, wrote, "Due to the economy, or maybe I should say recession, our membership is off about three percent over the previous year. A high percentage of our existing members are small business, middle-income, working executives. Increasing the net cost of club membership [by denying deductibility of dues] will prompt many employers to discontinue such support of their employees. Now comes the serious part, jobs, for women and minorities. As you know, our industry employs a high percentage of these groups. I would project [that denying the deductibility of dues] would result in a 20-percent layoff of employees and a 15-percent loss of club revenue."

In addition, these changes would deny important business opportunities to many small businesses and small business executives who rely on them for critical marketing activities. Business development is good for America and should be encouraged. The government should not engage in determining how and to what extent a taxpayer generates business. To repeal, in particular, club dues and business-entertaining expenses, and treat them differently from other business expenses is inherently inequitable.

The club and hospitality industries and their many employees have been unfairly targeted.

We believe in a strong economy and in investing for the future. The club community is a part of that future. The sales and services stimulated from the business use of clubs should remain legitimately deductible activities and are a critical element in a free enterprise economy.

IMPACT ON EMPLOYMENT AND REVENUE

Dues provide the dollars needed to cover fixed overhead in a club. Since variable costs in a club are relatively small, the only practical way to reduce costs and match reduced revenues is through payroll reductions. Very few clubs have the economic capacity to withstand revenue reductions. A recent sampling of clubs showed that over 64 percent of the club industry would foresee a potential decrease in their membership base if the deductibility of club dues were repealed. In addition, clubs would suffer a combined revenue loss of over $1 billion if club dues were repealed. The resulting effect is job loss, reduced business for suppliers and other lost opportunities.

City clubs, which are typically located in downtown business centers, will be particularly hard hit. Nine out of ten clubs indicate that changes to deductibility will result in loss of revenues. Many may not survive the blow. In addition to putting club employees out of work, the closing of these institutions would further reduce the economic strength so important to business centers in major urban areas.

The club community employs well over 600,000 full-time, part-time and seasonal employees. The projected loss of jobs is estimated to be between 68,000 to 78,000 for full-time positions. The loss in payroll taxes would be approximately $140 million a year. This does not consider the tens of thousands of part-time positions and related payroll taxes lost.

Many of these jobs are entry-level and held by minorities and women. Since the vast majority of these jobs have few transferable skills, those individuals losing jobs are likely to face some period of unemployment, probably prolonged. Many of these fine employees have been with their club employer for many years. Last spring, we received a number of handwritten letters (some in Spanish) from club employees concerned about losing their jobs. One such letter said, "I am an employee of a club. My title is a maid in the housekeeping department. This job is my only income. If the staff members are reduced, it may cause me my job. So please my Rep. Dan Rostenkowski I am opposed to the proposals that would end the deductibility of club dues." Another letter said, "... I earn $6.63 per hour, self supported [sic]. No other income. I am opposed to the proposals that would end the deductibility of club duse [sic]. I am sadden [sic] to hear at this possibility this could end my job."

These job-loss projections do not include the tertiary impact on suppliers, specialized equipment manufacturers and vendors that serve the club industry. The data also does not include the revenue and job losses that would result from a decline in corporate sponsorship of golf tournaments, which proceeds go to charity.

IMPACT ON SMALL-BUSINESS MARKETING EFFORTS

Changes to tax deductibility of dues and business meals would unfairly discriminate against the business women and men who are often the key source of membership in a club, especially city clubs. If legitimate dues deductions are disallowed, not only will many existing members resign, but many potential members may be discouraged from joining. These proposals would also hurt small businesses which depend on business entertaining for their marketing and advertising activities. The young entrepreneur or salesperson who cannot afford expensive media advertising, the young lawyer trying to build a practice, the new stockbroker working to develop customers, the accountant who

needs to meet clients in a relaxed setting to develop the essential relationship of trust— these are examples of the business people who need and use clubs and utilize these marketing approaches the most. They represent the middle-income taxpayers who, if denied such deductions, would be compelled to continue using these marketing tools and bear the cost themselves. More affluent taxpayers and large corporations will be able to turn to alternative marketing means like the print media and television advertising, which are still deductible.

Clearly, the rational business person is going to convert nondeductible dollars to some deductible use in order to draw business to the company or firm. As a result, the direct revenue benefit to the Treasury will be little. Many clubs will cut back and some will shut their doors resulting in thousands of club-industry employees working reduced hours or losing their jobs.

THE ADMINISTRATION'S PROPOSALS DO NOT PROMOTE TAX FAIRNESS

The Administration's proposals speak of tax fairness. In short, what has happened is that the club and hospitality industries are being used to illustrate that business cannot get away with special privileges that may have some type of perceived personal value and pleasure.

If, indeed, fairness is a central criterion in these tax proposals, then it is unfair to preserve the deductibility of other ways of conducting business. Expenditures for television and radio commercials, newspaper and magazines, or direct-mail advertising remain deductible. Likewise, so are offices in the newest and highest-rent buildings along with top-of-the line furniture and decor. In addition, a business can deduct expensive television "image" advertising, which makes no attempt to sell a product or service, while face-to-face business entertaining expenditures are not fully deductible. We have no quarrels with how other companies invest their money. We are simply hoping for an equitable balance.

The club industry is willing to pay its fair share, but there is no basis for treating these expenditures differently. The fairness standard of the proposals will not be followed if the government selects only one perceived area of "abuse" over others for disallowance. The government already has established "reasonable" expenditure levels in all areas of business. There is no rationale that can explain why club dues/business-meals expenditures are less valued than desks, carpets, or office rent.

One can argue that, at least in the case of dues/business meals, there is some possibility that a sale will be made or a business relationship enhanced that may help stimulate the economy. Conversely, does investing in a $5,000 inlaid mahogany desk rather than a $500 one truly enhance the businessperson's unique opportunities to increase his sales or business? Likewise, many companies offer employees exercise or workout rooms the value of which some may question in terms of generating business.

The thrust of the President's proposals appears to suggest that all income belongs to the government unless it is specifically remanded to the company or individual that earned it. Unfortunately this prompts critics of clubs and business lunches to argue that government is "paying for" part of the lunch, i.e., a government subsidy.

This argument is flawed. If the money spent on club dues and business meals is intended to maximize net income, then no subsidy is involved. From an economic standpoint, it makes no more sense to disallow these investments than it does for capital equipment, salaries, or advertising - all of which are used to generate profits. It is not the business of government to determine or influence how a company should invest or market goods or services. In effect, this says that the government knows better than an owner how his or her business should meet its objectives. Surely our society does not want to have government set arbitrary deductibility standards for business decisions.

One wonders whether we are observing economic policy crafted at the conceptual level

(such as the mission to create jobs) versus actual concerns about business development practices and maintenance of private sector jobs for low and middle income workers and suppliers who earn their living in the hospitality industry.

Taxpayers are required to substantiate the business purpose of such expenses. As a result, we believe the detailed business deduction substantiation requirements provide ample authority for the IRS to identify and prevent any misrepresentation by taxpayers.

Deductions are not allowed for that portion which is personal. Current documentation and substantiation requirements are very clear. Taxpayers claiming deductions for club dues and business meals must show a business purpose, and must keep clear and verifiable records. For deduction of club dues a taxpayer must show that the club was used primarily (more than 50 percent) for the furtherance of the taxpayer's trade or business and that the expenditure was directly related to the active conduct of such trade or business.

The taxpayer must also provide detailed records as to the number and duration of occasions on which the club was used during the taxable year for business, and the number of occasions on which the club was used during the year for nonbusiness activities.

For many taxpayers, the club is an extension of the office, and the business meal is simply another opportunity to meet and conduct business. For these individuals this is pursuing business. Business persons take clients and customers to clubs as well as to restaurants and to hotel meeting rooms. They meet over breakfast, lunch, or dinner because they believe such a meeting is a wise investment of their time and money. Whatever personal pleasure is derived from these activities is purely incidental. People engage in business entertaining to achieve an objective, not to dine for pleasure.

Arguably, there are many deductible business expenses that do contain a degree of personal pleasure, such as the quality of one's office furniture, the view from the penthouse office, the design of the employee's lounge or cafeteria, and the company exercise facility. And, what about the personal pleasure of a first-class plane ticket on business trips? The list is endless.

CONCLUSION

In conclusion, NCA supports the objective to have a strong economy. We are opposed, however, to any changes in the treatment of club dues, business meals, and entertaining expenses. If enacted, these changes will not stimulate a revitalization of our economy. The impact in human terms will be substantial and personal, particularly for entry-level service and club employees who have little expectation of being re-employed quickly.

Several years ago the Congress passed a luxury tax on airplanes, boats, jewels, furs and cars. Unfortunately, this tax change nearly ruined several industries, put many employees out of work, and added to our unemployment rolls. The lesson to be learned is that taxpayers will often change their habits when confronted with a change in tax treatment. I sincerely hope the Congress does not repeat this past mistake.

Mr. LEWIS. Thank you very much, Mr. Hurley.
Mr. Collie.

STATEMENT OF H. CRIS COLLIE, EXECUTIVE VICE PRESIDENT, EMPLOYEE RELOCATION COUNCIL

Mr. COLLIE. Mr. Chairman, I am Cris Collie, executive vice president of the Employee Relocation Council. I am joined today by ERC tax counsel, Peter Scott, of Coopers & Lybrand. Also with me is Gene Steurele, former Deputy Assistant Treasury Secretary, who co-authored the economic study, "Tax Treatment of Moving Costs: the Economic Impact on a Growing Economy," which we have submitted for the record.

We appreciate your giving us the opportunity today to present our views on the President's economic plan. I am representing members of the Employee Relocation Council, a professional association of 1,000 major corporations and governmental agencies and 10,000 relocation service companies concerned with the transfer of employees for job-related reasons. Our members relocate more than 220,000 American workers annually, many of whom are compelled to move in order to retain or obtain employment.

When President Clinton first introduced his plan, he lauded American companies as the promise of new economic health, and stressed the integral role they would undertake with Government in reversing the difficulties of the last two decades. We are in concert with the President in recognizing the significance of corporate America in the development of job opportunities and the rebuilding and strengthening of our work force.

However, we are also concerned that the general objective of this economic package—to create jobs—is in conflict with the deficit reduction provisions that would restrict deductions for work-related moving expenses. The deficit reduction provision creates a dual dilemma: additional restrictions on this expense specifically hurt people in the job market and furthermore, would counteract the job incentives features in other parts of the economic package.

Our concern deepened with the recent announcements of massive job dislocation due to the cutbacks in military bases.

Any restrictions on the deduction discourage mobility of labor. So states the aforementioned study, which was commissioned by the American Movers Conference and the Employee Relocation Council, and coauthored by Eugene Steurele and Joseph Cordes, chairman of the economics department at George Washington University and former deputy director of the Tax Division of the Congressional Budget Office.

The study demonstrates that a mobile workforce maximizes the return on investment in human capital for this Nation's economy. In fact, this positive link between labor mobility and productivity was earlier acknowledged by congressional tax-writing committees, which noted that "the mobility of labor continues to be important in the economy of the United States."

Current law already contains undue restrictions that prevent deduction for moving expenses. Restrictions intended to deny the deduction for the personal consumption element of moving already overstep sound policy and sometimes inappropriately limit or deny the deduction.

Restrictions on the moving expense deduction hamper firms, industries, and regions that depend on mobile workers.

In addition, the study points out that limitations on the deductibility of moving expenses also discourage workers from seeking more productive employment.

In short, moving expenses are a cost of doing business for employers or a cost of earning income for employees. Therefore, they should be considered fully deductible. We have no other policy in this country to help people move to areas where employment is available.

This provision was considered in this committee and on the Senate floor last year as a potential revenue raiser. We hope those scenarios will not be repeated this year as the importance of the moving expense deduction to economic recovery becomes better understood.

Nevertheless, we understand the need for deficit reduction and the challenges in dealing with budgetary problems. And we understand that everyone will be expected to contribute if we are to meet this important objective.

So, if the administration and Congress agree that further restrictions on the deduction for moving expenses are necessary, we are prepared to do our part.

The proposal under consideration by this committee, suggested by the Treasury Department in its February "Summary of the Administration's Revenue Proposals," denies the deduction for real estate closing costs and meals. If further restrictions are necessary, ERC believes this is the most palatable approach. We feel strongly that further restrictions would be inappropriate and counterproductive.

Thank you.

[The prepared statement and attachment follow:]

Employee Relocation Council
1720 N Street, NW
Washington, D.C. 20036
202/857-0857

Testimony of H. Cris Collie
Executive Vice President, Employee Relocation Council
before the House Ways and Means Committee
March 31, 1993

Mr. Chairman and members of the Committee, I am Cris Collie, Executive Vice President of the Employee Relocation Council, or E-R-C.

E-R-C is a professional membership association of 1,000 major corporations and governmental agencies and more than 10,000 relocation service companies concerned with the transfer of employees for job-related reasons. Our members move more than 220,000 American workers every year, many of whom are compelled to move to retain or obtain employment. We appreciate your giving us the opportunity today to present our views on the President's proposal to change the deduction for moving expenses and we look forward to working with the Committee.

We offer our support to this Committee as it drafts legislation to implement all of the tax and many of the spending provisions in the President's economic plan – including provisions to create jobs through the short-term stimulus program, to facilitate long-term economic security, and to reduce the structural deficit.

The President's package – and his timetable – are ambitious. We realize you face an early April target for approving a stimulus package designed to create hundreds of thousands of jobs to help ensure the economic recovery. And, after that, you must return to the budget reconciliation process and deal with the President's long-term investment package with its focus on jobs, education, investment incentives, and health care as well as with the proposals to reduce the deficit by $500 billion.

We wish you well as you develop this package.

Without question, the deficit is a serious problem that the American public wants solved. But the solution has not and will not come easy; the inevitable spending cuts and tax increases will require everyone to contribute to deficit reduction. We hope, though, that the final product from this Committee reflects its concern with sound tax and economic policy.

When President Clinton introduced his economic plan to a joint session of Congress in February, he lauded American companies as the promise of new economic health and stressed the integral role they would undertake with government in reversing the difficulties of the last two decades. We are in concert with the President in recognizing the significance of corporate America in the development of job opportunities and the rebuilding and strengthening of our workforce. However, we also are concerned that a general objective of the economic package – to create jobs – is undermined by the specific deficit reduction provision to restrict deductions for work-related moving expenses.

Our major interest today is the deduction for job-related moving expenses. Current law already includes so many restrictions on the moving expense deduction that many job-related moves are not deductible. We are concerned that additional restrictions on this business expense will hurt people in the job market and counteract some of the jobs incentives in other parts of the President's economic package. Our concern deepened with the recent announcements of massive job dislocation due to the cutbacks in military bases.

The Moving Expense Deduction is a 'Jobs' Issue

One of the main reasons President Clinton won the November election is his commitment to put people first by restoring our competitive position in the world economy. His short term stimulus package reflects his concern that our improving economy still needs help in the form of incentives to make it easier for the unemployed to find jobs. Moving expenses can directly affect the nation's employment picture. A study ("Tax Treatment of Moving Costs: The Economic Impact on a Growing Economy") prepared for us by Eugene Steuerle (former Deputy Assistant Treasury Secretary) and Joseph Cordes (Chairman of the Economics Department of George Washington University and former Deputy Director of CBO's tax division), which has been separately submitted to be printed in the record, finds that in an ideal world there would be no restrictions on job-related moving expense deductions. Any restrictions, according to Steuerle and Cordes, can affect the mobility of labor and, therefore, can affect the ability to match the right worker and the right job to create the most productive economy.

This study indicates that any restrictions on deducting moving expenses can slow economic growth; the tax laws already include substantial restrictions. Our position is that no additional restrictions should be adopted. We want the economic recovery to continue. And we believe additional restrictions would discourage, not encourage, economic recovery.

Moving Helps Individuals and the Economy

In work-related moves, people move out of self-interest to increase their incomes or improve their standards of living, or retain their jobs. But it also is in the nation's economic self-interest for people to move freely. Labor mobility facilitates matching the right people with the right jobs. It means people with the right training and education can be matched with jobs that use that training well. Additionally, some economic studies conclude that workers who move may increase not only their own income and the productivity of their employers, but also the output of other parts of their new community. Consequently, there is a positive link between labor mobility and productivity. Artificial barriers to this matching process should be avoided.

Restrictions on the Deduction Discourage Labor Mobility

Labor mobility helps improve economic productivity and can provide the U.S. with a competitive advantage over other nations. Historically, the American work force has been more mobile than workers in other countries. A few years ago, *The Economist* reported that American manual workers are "18 times more likely to move to a different state to find or keep a job than Britons...." If we can preserve labor mobility, we will preserve a very important competitive advantage over countries where workers are less willing to move and government policies do not encourage mobility.

In an ideal world, there would be no restrictions on the deduction of work-related moving expenses. The Steuerle-Cordes study indicates that any restriction on the deduction is a barrier to the mobility of labor and, necessarily, is a barrier to the process of matching people and jobs. Maintaining such barriers is against the economic interest not only of American workers but also of the nation. Such barriers slow economic growth.

For the individual, denying the deduction for work-related moving expenses substantially increases the costs of the move. The increased tax costs hamper labor mobility by adding to moving costs and, thereby, reduce the benefits of moving.

Denying the deduction also hurts the productivity of employers. Limits on the deduction discourage workers from moving when they would be more productive in another job. This makes it harder for employers to hire the best person for the job simply because that worker may not be able to afford to make the move.

Job-Related Moving Expenses are a Necessary Cost of Earning Income

Congress's first action on the moving expense deduction began with the premise that moving expenses are a business expense. The congressional report on the 1964 legislation that codified the moving expense deduction explains that moving expenses "are treated essentially the same as business expenses...."

We agree that moving expenses basically are a business expense. They are a cost of doing business and earning income and, as such, generally should be considered fully deductible. However, some moves do involve a personal consumption element; for example, moves into better houses, moves to take advantage of better schools, etc. The costs of these moves should not be deductible. We accept the policy position that expenses should not be deducted unless the move is work-related. To achieve this end, many restrictions already limit, and in some cases prevent, deducting the costs of moving from one location to another. However, current restrictions already rigidly limit the deduction to work-related moves. That is why we oppose further restrictions on the deduction.

Undue Restrictions Under Current Law

Current law already includes restrictions that unduly prevent deductions for moving expenses. Arguably, the restrictions were adopted to make sure that the moving expense deduction is only available for "work-related" moves and not for personal moves. Unfortunately, those restrictions already go too far. They sometimes inappropriately limit or deny deductions for what actually are job-related moves. They discourage a result – labor mobility – that we should encourage. Some of those restrictions are outlined below.

Full-time Job. One restriction intended to limit the deduction to job-related moves focuses directly on the individual's employment status after the move. It requires the individual to be a full-time employee for at least 39 weeks in the 12 months following the move. If the individual meets this test, he or she qualifies for the deduction.

Mileage Requirement. Another restriction – a mileage requirement – tries to carve out moves that presumptively are for personal, as opposed to work-related, reasons. This restriction presumes that a move is not job-related unless the job would add at least 35 miles to the individual's commute from their old home to their new job. If the job change would add fewer than 35 miles to the individual's drive to work, then the expenses of moving closer to the new job are not deductible. Congress increased the original mileage limit in 1969 over some members' objections that the increase would deny the deduction for many job-related moves. In 1976, Congress decided that the mileage limit had been raised too high and cut it back to its current level: 35 miles. The reasons for the reduction in 1976 are equally relevant today: the congressional tax committees found that mobility of labor is important to the economy; job-related moving expenses are a cost of earning income; and the higher mileage restriction leads to longer commutes with higher commuting costs when we need to conserve energy.

Househunting Expenses. Current restrictions also limit the amount of a deduction available for expenses of looking for a new home and selling or renting an old one. The limit for househunting and temporary living quarters is $1500 and the limit for selling, buying, or settling leases is $3000, less the amount claimed under the $1500 cap. These are the same amounts adopted in 1976, and are obviously outdated. Despite Treasury's recommendation in 1986 that they be increased, the caps have never even been indexed for inflation.

Below-the-line Deduction. The moving expense deduction also is restricted by the overall limitation on itemized deductions. Before 1986, the moving expense deduction was an above-the-line adjustment to gross income – making it available to a larger number of individuals. The decision to make the deduction a below-the-line deduction effectively eliminates it for a large number of individuals, even if they move solely because of a new job and they meet all other restrictions.

Conclusion: No Additional Restrictions Should Be Adopted

E-R-C wants to see the economic recovery continue. Our position is that the current restrictions on moving expense deductions are more than adequate to limit this deduction to work-related moves and that additional restrictions would be inappropriate. Additional restrictions would discourage, rather than encourage, the economic recovery. Restrictions would hamper firms, industries, and regions that depend on mobile workers and would simultaneously help competing firms that rely on workers who are not affected by mobility. As Congress considers the President's economic package, it also is important to remember that we have no other policy in this country to help people move where the jobs are. Any change that further restricts the deduction will only discourage work-related moves and economic growth.

We recognize that the moving expense deduction was considered in this Committee and on the Senate floor last year along with a host of other potential revenue raisers. We hope this year this Committee recognizes the importance of the deduction to the economic recovery and jobs, and that the scenarios from last year are not repeated.

Nevertheless, we understand the need for deficit reduction and dealing with budgetary problems. And we understand that everyone will be expected to contribute if we are to meet this important objective. So, if the Administration and Congress agree that further restrictions on the deduction for moving expenses are necessary, we are prepared to do our part.

The proposal under consideration by this Committee, suggested by the Treasury Department in its February Summary of the Administration's Revenue Proposals, denies the deduction for real estate closing costs and meals. If further restrictions are necessary, E-R-C believes this is the most palatable approach. We feel strongly that further restrictions would be inappropriate and counterproductive.

Tax Treatment of Moving Costs:
The Economic Impact on a Growing Economy

A Paper Prepared by
Joseph Cordes and Eugene Steuerle
for the American Movers Conference and the Employee Relocation Council

INTRODUCTION

A hallmark of American society is its mobility. Census data show that in the course of a single year, almost one-fifth of the total population changed their place of residence.[1] The Survey of Income and Program Participation (which significantly understates the number of movers) indicates further that over one-fourth of the population moved within a single 2 1/2-year period.

When Americans move, economic considerations play an important role. One study, for example, estimated that between 70 and 85 percent of those who move to a different Standard Metropolitan Statistical Area (SMSA) or county did so for economic reasons.[2] The search for new employment opportunities figures prominently in the decisions of many movers. The aforementioned study, for example, also reports that between one-third to one-half of all moves were motivated by a decision to change jobs. Those looking for work also are significantly more apt to move than those not looking for work and those who are retired. For instance, among those 45-54 years of age, 28.1 percent of those looking for work moved over a 2 1/2-year period, whereas movers comprised only 12.2 percent of those with a job and not looking for a job and 13.9 percent of those not in the labor force.[3]

This movement has been a major source of dynamism in the American economy. The nation is mainly one of immigrants, and the descendants of those immigrants have moved from east to west, from south to north and back again, in search of a better way of life.

Although ideally one might wish that movement would not be required for improvements in economic well-being, individuals are often compelled to move by circumstance, opportunity, barriers to progress in one area, and other dynamic aspects of the economy. Seen in this context, mobility of workers plays an important role in helping market economies adapt to changing circumstances. This point has not been lost on some observers from Europe, where workers are generally less mobile than in the United States. The respected international weekly The Economist, for example, notes that American manual workers are "18 times more likely to move to a different state to find or keep a job than Britons," and goes on to suggest that the United Kingdom adopt a series of policies to facilitate labor mobility, including, among others, allowing moving expenses to be tax-deductible.[4]

Moving, of course, can involve significant costs. There is limited information on out-of-pocket moving expenses paid by individual workers, but when firms relocate employees, they often reimburse employees for some of their expenses. These reimbursements provide some indication of the costs of moving. According to 1991 data collected by the Employee Relocation Council for participating firms, the average cost for moving a homeowning transferee was $46,667; for moving a homeowning new hire, $33,467; for moving a renting transferee, $12,290; and for moving a renting new hire, $8,227. It should be noted that these costs do not include other costs to the employee that might not be reimbursed by the firm, either because of limits on total reimbursable expenses or because some expenses do not qualify for reimbursement.

TAX POLICY TOWARD MOVING EXPENSES

Tax policy has always been fairly restrictive in allowing moving expenses to be deducted. During the latter half of the 1980s, however, the general thrust of tax policy has been to reduce even more severely the extent to which moving costs are deductible in computing taxable income. These changes have come about because of both tax legislation and the failure to adjust limits on some moving expense deductions for rising costs.

Despite the large number of moves in the United States, only a small percentage of those moves have ever qualified for a moving expense deduction. Even before the passage of the Tax Reform Act of 1986, for instance, no more than 1.74 percent of returns filed for moving expenses.[5] The requirements of the law for any deductibility at all have been fairly strict and designed to insure that a move was mainly for work-related purposes. Thus, the law requires that the distance between an individual's new place of employment and former residence must be 35 miles greater than the distance between the individual's former place of employment and former residence. The individual must be a full-time employee for at least 39 weeks in the 12-month period following the move (although this could be waived if the employee is transferred or separated from work, and in certain hardship cases).

These restrictions have been sufficiently stringent to insure that only a small fraction of moves actually received a tax deduction, as is evident by comparing the small fraction of households receiving a tax deduction with the much larger fraction of households

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[1] Source: U.S. Bureau of the Census, Current Population Reports, Series P-20.
[2] Ann P. Bartel, "The Migration Decision: What Role Does Job Mobility Play?" American Economic Review, December 1979, v. 69, pp. 775-787.
[3] Diana DeAre, "Longitudinal Migration Data from the Survey of Income and Program Participation," Current Population Reports Special Studies, Series P-23, No. 166. Washington, D.C.: U.S. Bureau of the Census, 1990.
[4] "Wage Sclerosis," The Economist, August 19, 1989, pp. 12-13.
[5] U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, Washington, D.C.: Superintendent of Documents, various years.

which move in a given year. The cautious approach to deductibility of moving expenses taken by the tax code is underscored by the fact that other costs of moving, that are not deductible, could easily be considered to be costs partially or wholly related to work. Students who move for educational purposes pay costs that offset later gains in earnings. Households, such as single heads of households who spend part of the day caring for children, sometimes move to take part-time work. Finally, the 35-mile limit can be rather restrictive, as the additional commuting costs of going to a job even a few miles further away could be substantial. Moving closer to a new place of work, even if only a few miles, is a reasonable response to the increased cost associated with the new job.

This is not to argue that some restrictions are unnecessary. Some moving expenses are not related to the cost of work, and therefore, should not be tax deductible. The point is simply that mileage and full-time work restrictions prevent many taxpayers from deducting any expenses of moving, even when some or all of those expenses may be work-related.

Statutory Changes

Prior to 1986 legislation, taxpayers meeting most of the aforementioned work-related conditions were generally allowed an unlimited deduction for direct costs of moving household goods, as well as indirect moving costs up to a limit. These deductions were taken "above-the-line," which means that taxpayers were able to deduct moving expenses without regard to whether they itemized other deductions. In 1986, these provisions were changed to recharacterize moving expense from an "above-the-line" deduction to one taken "below-the-line." Thus, taxpayers who make use of the standard deduction – principally, those who rent and do not have itemizable mortgage interest and property tax deductions – were no longer able to deduct moving costs. When these taxpayers were compensated by their employers for the cost of moving, therefore, they were required to treat such compensation as fully taxable income without any offsetting deduction. By itself, changing moving expenses to a "below-the-line" deduction increased (after-tax) moving costs for almost 900,000 taxpayers per year.[6]

Inflation & Movement Away from Proposals Made in Treasury I

In 1984 the Treasury Department recommended that increases in the cost of moving justified an increase in the overall dollar limitation on the deduction for indirect moving expenses from $3,000 to $10,000. In addition, it proposed that the dollar limitation applicable to temporary moving expenses and round-trip travel expenses be increased from $1,500 to $3,000. For moves outside the United States, the overall dollar limitation would be increased from $6,000 to $10,000 and the dollar limitation applicable for temporary moving expenses and round-trip travel expenses would be increased from $3,000 to $6,000. These costs also would have been indexed as of January 1, 1986.[7]

From 1986 to 1993, inflation has increased consumer prices by more than one-fourth, implying that the $10,000 limit suggested by the Treasury Department would have been increased to more than $12,500. Other limits would have received corresponding increases.

Data supplied by the Employee Relocation Council imply that even larger increases may have been in order. Between 1986 and 1991, average relocation costs for employees of their surveyed companies increased by 7 percent per year. Extrapolating that data to 1993 implies an overall cost increase of about 60 percent since the beginning of 1991. This increase, of course, could be due to several factors, including an increased willingness of firms to cover additional costs of moving to attract employees. The index proposed by Treasury, nonetheless, was probably too low. Moving costs might be expected to grow in line with income and asset growth in the economy, rather than simply inflation. As average home value increased, for instance, so might sales costs associated with buying and purchasing those homes.

Regardless of what would be the correct index, the limits now applying in the law are neither indexed nor raised to the amounts suggested by Treasury even for 1986. Hence, many legitimate costs of work are not deductible.

The Response of Companies

As moving expenses have become less deductible, companies have responded in part by developing assistance programs to compensate employees for the additional federal tax liability that employees pay on their reimbursements for moving expenses. About 90 percent of the nearly 500 firms who participated in the Employee Relocation Council survey reported such programs.[8] Most firms also indicated that they had a separate assistance program for nonitemizers.

THE ECONOMICS OF MOVING

As noted, some moving expenses might be thought of as motivated mainly by desires of households to choose new surroundings, lifestyles, and perhaps bundles of local public goods, such as schools. To deal with these types of "consumption-related" moving expenses, the tax code restricts greatly the number of movers who might even be eligible to deduct moving expenses and tries to insure that they are job-related.

Moving Expenses as Costs of Investing in Human Capital

Clearly, however, a principal reason for moving is to increase earnings. Going back to the work of Nobel laureate economist Sir John Hicks, economists have argued that "differences in net economic advantages, chiefly differences in wages, are the main

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[6] According to the Statistics of Income, in 1986, 1,790,938 taxpayers claimed moving expense deductions on their returns. In 1987, the number fell to 960,651; and in 1989 fell further to 898,825. (Note that the change in the tax deduction could also have reduced the number of returns with a deduction for moving expenses by creating a disincentive to move).
[7] U.S. Department of Treasury, Tax Reform for Fairness, Simplicity and Economic Growth, November 1984, pp. 122-123. Washington, D.C.
[8] Employee Relocation Council, 1988 Relocation Trends Survey, 1989. Washington, D.C.

causes of migration."[9] Drawing on the work of T.W. Schultz and G.S. Becker[10], L. Sjaastad formulated a model in which the migration is affected not only by earnings differentials, but also by factors such as moving expenses, job search costs, psychological costs, and uncertainty.[11]

The key insight of these migration models is that people move as a means of maximizing the potential earnings that they can acquire through their particular mix of skills and talents – e.g., their human capital. Under this view, costs of moving become costs of earning income. Economists who have analyzed migration have found the human capital model to be quite useful in explaining the behavior of movers.[12] Among the findings of research on the determinants of migration:

- Income opportunities at the destination are an important determinant of the decision to move. One study, for example, found that a "ten-thousand dollar expected increase in the present value of husbands earnings increases the probability of interstate migration by 6 percent."[13]
- Jobs attract migrants, but migrants do not appear to substitute fully for local workers, implying that the net gains from migration include not only the additional productivity from hiring the best worker for the job, but also spillover effects to other parts of the community;[14]
- Moving costs are a barrier to migration. Many studies, for example, find that higher costs of living at the destination discourage migration, as does increased distance, which is correlated with increasing costs of moving.[15]

Implications of the Economic Model

The economic model of migration suggests there are several ways in which migration/moving enhances productivity and economic performance.

Long Run Economic Efficiency. Over the long run, migration/moving enhances economic efficiency by facilitating the match between the wages and salaries paid to workers and their productivity. An important condition for production efficiency in a market economy is that earnings of workers and returns to capital correspond to the value of the output produced by these factors of production. If labor and capital are **mobile**, the private interests of workers and their employers provide enough incentive for this to happen.

There are a variety of reasons why the productivity of workers may vary by location. Skills developed at one job may be worth more to another employer located in a different city. Within the same company, skills developed in one location may be worth more elsewhere in the company. (This would be mirrored by a company's decision that the person best qualified for a particular position needs to be transferred). In each of these cases, the efficiency of labor requires that workers move and relocate.

Responding to Economic Shocks and Technological Change. In the short run, unforeseen shocks to the economy, as well as technological change, will affect the productivity and the demand for labor in different geographical regions. Workers whose skills commanded a relatively high wage in a particular area may find those skills diminished in value as an everchanging dynamic economy adjusts to cyclical and technological shocks. If workers respond by refusing to accept employment at wages below what they expect, the unemployment rate in the region affected by the shock will rise. Migration from relatively low to high labor demand areas helps mitigate this effect, thereby helping the economy to operate as close to its full-employment potential as possible.[16]

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[9] John R. Hicks, The Theory of Wages, London Macmillan Press, 1932.
[10] Theodore W. Schultz, "Investment in Human Capital," American Economic Review, March 1961, v. 51, pp. 1-17; Gary S. Becker, Human Capital, New York: National Bureau of Economic Research, distributed by Columbia University Press, 1964; and Larry Sjaastad, "The Costs and Returns of Human Migration," Journal of Political Economy, Supplement, Oct. 1962, v. 70, pp. 80-93.
[11] L. Sjaastad, ibid.
[12] For useful surveys of economic models of migration, see Michael J. Greenwood, "Research on Internal Migration in the United States: A Survey," Journal of Economic Literature, June 1975, v. 13, pp. 397-434; Michael J. Greenwood, "Human Migration: Theory, Models, and Empirical Studies," Journal of Regional Science, Nov. 1985, v. 25, pp. 521-544; and William J. Kahley, "Population Migration in the United States: A Survey of Research," Economic Review, Jan./Feb. 1991. Atlanta: Federal Reserve Bank of Atlanta.
[13] Solomon W. Polacheck and Frances W. Horvath, "A Life Cycle Approach to Migration: Analysis of the Perspicacious Peregrinator," in Ronald Ehrenberg (ed.), Research in Labor Economics. Greenwich, Ct.: JAI Press, 1977, pp. 103-49. Frank W. Porell, "Intermetropolitan Migration and Quality of Life," Journal of Regional Science, 1982, v. 22, pp. 137-158, finds economic factors to be more important in explaining migration than quality of life factors. William Kahley, op. cit., p. 19, finds that both a state's income growth and expected pay have a positive effect on in-migration.
[14] Michael J. Greenwood and Gary L. Hunt, and John M. McDowell, "Migration and Employment Change: Empirical Evidence on the Spatial and Temporal Dimensions of the Linkage," Journal of Regional Science, May 1986, v. 26, pp. 223-35.
[15] Theoretical analyses include A. Schwartz, "Interpreting the Effect of Distance of Migration," Journal of Political Economy, Sept./Oct. 1971, pp. 1012-1031; Ian P. King, "A Natural Rate Model of Frictional and Long-Term Unemployment," Canadian Journal of Economics, Aug. 1990, v. 23, pp. 524-545; and Simon M. Burgess, "A Search Model With Job Changing Costs: Eurosclerosis and Unemployment," Oxford Economic Papers, Jan. 1992, v. 44, pp. 75-88. Empirical evidence is found in Janet C. Hunt and James B. Kau, "Migration and Wage Growth: A Human Capital Approach," Southern Economic Journal, Jan. 1985, v. 51, pp. 697-710; Mark C. Berger and Glenn C. Blomquist, "Geographic Mobility and Quality of Life," Paper presented at the annual meeting of the Population Association of America, March 1989; and Richard Kahley, op. cit., p. 19.
[16] See King, ibid., and Burgess, ibid., for theoretical analyses. Empirical studies include: Julie DaVAnzo, "Does Unemployment Affect Migration," Review of Economics and Statistics, 1978, v. 60, pp. 504-514; and Donald R. Haurin and R. Jean Haurin, "Net Migration, Unemployment, and the Business Cycle," Journal of Regional Science, May 1988, v. 28, 1988, pp. 239-254.

Preventing barriers to mobility is also important for insuring that human resources not be underemployed. Being employed somewhere is not enough. Again, when technology, shifts in demand, and other economic shocks increase the value of a worker's product in a different area (or decrease her productivity in an existing one), deterrents to mobility will act as barriers to the full employment of that person's skills. Productivity and national income decline along with the decline in her output.

TAX POLICY IMPLICATIONS

The (simple) human capital model of moving has fairly direct implications for the tax treatment of moving expenses. To see this, we first establish the properties of a well-functioning set of labor markets in the presence of moving costs, but in the absence of taxes.

Worker-Mover's Choice

Consider the case of a worker who is trying to decide whether to accept an offer of a job that requires a move. Assume for simplicity that the worker must "pay" moving expenses. (It is easily shown that the same conclusions would hold if, instead, the prospective employer paid the worker's expenses).

Define E_{mj} to be the present value of the earnings that a prospective mover would receive if she were to move to location j, and E_{mi} be the present value of the earnings she will receive if she stays at location i. Let M_{ij} be the cost of moving from location i to location j.

Then the human capital model of migration/moving implies that if the worker is to move, the present value of earnings at destination j must equal or exceed the sum of the present value of earnings at origin i plus the costs of moving.

$$E_{mj} \geq E_{mi} + M_{ij} \tag{1}$$

Employer's Choice

Prospective employers face a choice between hiring local workers and movers. From the employer's perspective, the compensation package that it is prepared to pay someone to move from destination i to destination j, which determines the present value of the earnings the worker can expect to receive if she moves, E_{mj}, will equal the compensation package it would have to offer the best qualified local worker to accept the job at destination j, E_{lj}, plus the difference in productivity between a mover and a local hire.

$$E_{mj} = E_{lj} + [P_{mj} - P_{lj}] \tag{2}$$

Note that in this simple case, if there is no gain to the employer in the form of greater productivity from hiring a mover, the compensation package the employer is willing to offer a mover will be the same as that which would be offered to a local worker.

Equating the right-hand sides of (2) and (1) yields the condition under which a market comprised of rational workers and employers will result in a worker moving from location i to accept employment at location j:

$$E_{lj} + [P_{mj} - P_{lj}] = E_{mi} + M_{ij} \tag{3}$$

That is, the compensation package the employer is willing to offer a potential mover to relocate to destination j must equal the compensation package the potential mover is earning at the origin i plus moving costs.

In a well-functioning, competitive labor market, wages will reflect the value of worker productivity so that $E_{lj} = P_{lj}$, and $E_{mi} = P_{mi}$. Substituting these expressions into (3) yields the condition at the margin under which employers are willing to hire movers and at which workers are willing to move:

$$P_{mj} = P_{mi} + M_{ij} \Longrightarrow [P_{mj} - P_{mi}] = M_{ij} \tag{4}$$

This condition expresses the sensible, but important result that in a well-functioning labor market, in the absence of taxes, moves take place at the margin when a move increases a worker's productivity by an amount at least equal to the costs of moving the worker.

Note that this means that some moves will not take place even though the worker's productivity would be greater at another location. When the increase in productivity is less than the real costs of moving the worker, the movement is uneconomical. This is as it should be in a well-functioning market. Moving requires the use of scarce resources. If these costs are not offset by added productivity gains, the economy does not benefit from having workers move to change jobs.

Labor Market with Moving Costs and Taxes

The principle of tax neutrality holds that a tax will be neutral when it does not interfere with the choices that consumers or businesses would make in the absence of taxes.

In the case of labor markets with moving costs, neutrality obtains when (a) income is taxed, and (b) moving costs are treated by the employee as costs of earning that income. An income tax can be neutral with respect to the moving decision in one of two ways. If workers pay moving expenses out-of-pocket, neutrality requires that workers be allowed a full deduction for these expenses. If employers reimburse workers for moving costs, these costs must be fully deductible as a legitimate expense of doing business to the employer, and should not be included in the taxable income of the employee.

In a tax regime in which moving expenses are treated neutrally, workers and employers will compare after-tax gains in earnings and productivity with after-tax moving expenses. (The tax rate may vary depending on whether moving expenses are borne and deducted against income by the individual or by the employer). In that case, if the tax rate is **T**, expression **(4)** becomes:

(5)

$$[P_{mj} - P_{mi}]\,(1\text{-}T) = M_{ij}(1\text{-}T) ==> [P_{mj} - P_{mi}] = M_{ij}$$

The important feature of expression **(5)** is that moves that would take place in the absence of an income tax would also take place in the presence of an income tax that allowed full deductibility of moving expenses. That is, moves would take place when the added productivity exceeded the real costs of moving. Thus, full deductibility of moving expense maintains the economic incentive to move provided by the market place.

Incomplete Deductibility

Suppose, however, that moving costs are not allowed to be treated for tax purposes as costs of working. In this case, it is easily shown that moves will take place when condition **(6)** is satisfied:

(6)

$$[P_{mj} - P_{mi}]\,(1\text{-}T) = M_{ij}\,(1\text{-}aT)$$

where **a** is the effective fraction of moving expenses that can be deducted. If we rearrange **(6)** a little, we have:

(7)

$$[P_{mj} - P_{mi}] = M_{ij}\,[(1\text{-}aT)/(1\text{-}T)]$$

Note that in comparison to condition **(5)**, moves will only take place if the gain in productivity exceeds moving costs by a factor greater than 1. This factor rises as **a** (the fraction of moving expenses that is effectively deductible), falls. For example, if moving expenses were not deductible at all, productivity at the destination would have to be 1/(1-T) times as large as moving expenses in order for moving to make economic sense. Intuitively what happens under incomplete deductibility is that the government claims its full share of the economic gains that result from moving, while bearing only a partial share of the costs.

From the perspective of workers and companies, denying deductions for moving expenses has the same effect as would an increase in the real cost of moving to workers and businesses. It is difficult to calculate precisely the extent to which existing limits on deductions for moving expenses have served to effectively increase the cost of moving. Nonetheless, some clue can be obtained by the amount by which companies pay additional expenses to employees to compensate for the taxes they now have to pay for reimbursed moving expenses. In 1992, the Employee Relocation Council estimated that when current employees received moving assistance payments from a company, they received an average of $4,020 to compensate them for federal tax liability owed on company-provided moving assistance payments.

When one particular method of payment is used – the "flat percentage method" – these tax gross-up factors ranged from 20 to 50 percent, with a median of 28 percent.[17] That is, the employee reimbursement would be treated as taxed at a 28 percent rate. Many companies, however, relied upon computations that were more specific to the taxpayer's circumstances. In addition, most companies report providing additional reimbursements for the tax on the tax reimbursement, that is, on federal tax liability payments made by the employer as part of the assistance package. For example, if a taxpayer is in the 28 percent tax bracket, a typical formula would gross up actual moving costs by 39 percent, thus accounting for the taxes on the additional compensation paid to cover taxes on reimbursed moving expenses. (Some companies also include state and local and FICA taxes in their gross-up).

ECONOMIC COSTS OF LIMITING DEDUCTIBILITY

Though moving costs increase for tax reasons when they are not fully deductible, there is no increase in the underlying economic costs of moving. Thus, failure to allow full deductibility of moving expenses causes workers and employers to perceive moving costs to be higher than they actually are. In the parlance of tax economics, less than full deductibility of moving expenses creates a **tax wedge** between the cost of moving faced by workers and employers, and the true economic cost of moving.

Costs of Fewer Moves

Because less-than-full deductibility creates a tax wedge, some moves that would otherwise be economically beneficial to workers and employers will not take place. It is well-established in the public finance literature that when this happens, there will be a reduction in overall economic well-being, the size of which is determined by how responsive markets are to a tax-induced change in the price or cost of the activity affected by the tax wedge.[18]

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[17] Employee Relocation Council, op. cit., p. 16.

[18] For discussion of how tax wedges lower economic well-being, see Harvey S. Rosen, Public Finance, 3rd Edition. Homewood, Ill., 1991, Chapters 13 and 14.

Some economic choices may be relatively unresponsive to the introduction of tax wedges, because either the demand or the supply of the activity is fairly unresponsive to changes in its price. There is, however, no reason to believe that moving decisions should fall into this category. Goods and services that are often considered unresponsive to taxes are those that tend to be demanded in the same amount or supplied in the same amount no matter what the tax. For instance, some minimal amount of food may be demanded no matter what the tax rate, or the supply of land or other factor may be fixed even if a property tax is imposed on the land.

The economic model of migration, however, suggests that moving should be responsive to wedges created by the tax system for several reasons. First, the difference in net after-tax income plays an important role in the decision to move. Many companies also act as if the after-tax cost of moving matters to workers when they gross-up such reimbursements to reflect taxes. The supply of moving services should also be quite responsive, as there are few fixed factors involved. The costs of moving are largely the labor costs associated with paying for the services of moving companies, realty companies, lending institutions, and similar organizations.

Differential Treatment of Industries and Companies

Additional economic costs are imposed when tax wedges fall unequally on different sectors of the economy. Increases in moving costs resulting from less-than-full deductibility fall more heavily on workers who face the largest costs of moving, and on companies who rely relatively heavily on hiring new employees and/or on transferring existing employees to adapt their labor force to changing demands. As a consequence any tax wedge resulting from limiting deductibility may unintentionally discriminate among different industries – to the extent moving is more important in some industries than in others – and among firms in the same industry – to the extent that some firms depend more on hiring "movers" than do other firms.

Differential Treatment of Industries. Imposing a moving tax wedge could affect different industries in several ways. Suppose that the ability to relocate workers within the firm plays a more significant role in the "production function" of some goods and services than others. In that case, failure to allow full deductibility of moving expenses has effects similar to those of taxing factors of production more heavily when employed in some activities than in others. This has effects quite similar to selective excise taxes.

Similar observations apply to industries that might be concentrated in certain regions of the country. To the extent such firms and regions need to "import" skilled workers from elsewhere, anything less than full recognition of the costs of moving would make it harder at the margin for such enterprises to attract the workers they need.

Differential Treatment of Firms. At the level of the individual firm, imposing a moving tax wedge could be expected to have differential effects depending on the size and the age of the firm. There is some evidence that smaller companies pay more for relocations than their larger counterparts, apparently because of differences in "pricing clout" in negotiating moving costs with moving companies themselves.[19] If this is correct, the denial of tax deductibility exacerbates this problem and discriminates against smaller companies.

At another level, the issue is more one of competition among firms, whether or not in the same industry or of the same size. If firms differ in the extent to which they rely upon mobile workers, the denial of appropriate deductions can serve to reduce competition – in somewhat the same way as if the government randomly picked firms or employees of particular firms to pay different tax rates.

This anticompetitive aspect of the tax law may especially hit new firms that depend initially upon hiring workers from different areas. Suppose a new firm believes it has a more efficient production process, or it has an invention it wants to develop, or it believes that existing firms have grown stagnant. Then denial of tax deductibility of legitimate moving expenses operates as a barrier to increased market competition. The economic literature makes it clear that such anticompetitive policies are harmful to the economy. When such behavior is exhibited in the private sector, it is often fought through such devices as antitrust policy. When resulting from the tax code, however, there is no government reprieve available.

SUMMARY AND CONCLUSIONS

Historically, American workers and companies have benefitted from a high degree of worker mobility. U.S. tax policy has attempted to avoid interfering with market incentives for mobility by allowing moving expenses to be deducted under some conditions. In recent years, however, the combined effects of changes enacted in the Tax Reform Act of 1986 and of inflation have been to place limits on deductions for moving expenses, even though the Treasury Department recommended that limits on moving expenses actually be raised in its comprehensive report on tax reform.

Economic models of migration imply that moving facilitates the formation and the allocation of human capital. These models suggest that allowing full deductibility of legitimate moving costs would be sound tax policy, especially at a time when policymakers are considering ways of deepening the human capital of American workers.

[19] Source: Nation's Business, August 1990, "Small Firms Pay More for Relocations," p. 8.

Mr. LEWIS. Thank you very much, Mr. Collie.
Rear Admiral Cooney.

STATEMENT OF REAR ADM. DAVID M. COONEY, USN (RETIRED), PRESIDENT AND CHIEF EXECUTIVE OFFICER, GOODWILL INDUSTRIES OF AMERICA, INC., ON BEHALF OF APPRECIATED PROPERTY WORKING GROUP

Admiral COONEY. Thank you, Mr. Chairman.

I am David Cooney. I am the president and chief executive officer of Goodwill Industries of America, Inc., and I am here visiting with you on behalf of an ad hoc group which is called the appreciated property working group, is an informal coalition of more than 60 universities, hospitals, charitable organizations and the like, who are concerned about supporting the President's initiative in respect to the treatment under the alternative minimum tax of gifts of appreciated property.

There seems to have been a myth grown up about this proposal, Mr. Chairman, which would cast the idea that this is a proposal which would give a tax loophole to the very rich. And so my colleagues in the working group asked me to stop by and visit with you briefly and point out that what we are talking about is something which has a significant potential impact on social service delivery organizations.

Goodwill Industries is well known as a recycler and responsible handler of donated and used goods. Eighty percent of Americans know about us and approve of what we do. But only 30 percent of the American public knows that what we do is spend the money that we derive from these enterprises on providing job training and employment to disadvantaged and disabled adults. We provided services to 122,000 people last year. We helped more than 22,000 of them get jobs in competitive industry. Our projections indicate that unless there is a major turnaround in the economy, that by the year 2005 we are going to be serving as many as 400,000 clients a year, and we are going to have to be earning $4 billion a year to pay the price of doing that.

Quite frankly, although we are an entrepreneurial organization, as are many other social service organizations, we need from time to time to augment gifts of money with items of great value which can be converted to cash and be used as an incentive for the establishment of scholarship programs, the acquisition of capital base, and funds for construction.

In fact, you do not raise money in this country to build a building unless somebody gives you a lot upfront, and the rest of the people come along and match it. And it is exactly that kind of thing that we would be more greatly enabled to acquire if there is due recognition of the fact that those who donate tangible items of property to us can write them off for their full market value instead of it being depreciated because they, themselves, fall into a special tax category.

It is a corny joke, but the difference between the rich and the poor is that the rich people have money. But it is also true that if you want money, you have to go and see people who have it and who can give it to you in large sums to stimulate the kind of thing that we need in this country.

I will give you a specific example. Last year, in Chicago, we were offered a real property gift which was assessed at a value of more than $250,000. By the time we gave counsel to the potential donor and he sought advice from his own tax consultant, he withdrew the gift because it was just too complicated, and it was going to cost him too much money. I could have taken that $250,000 and converted it into training opportunities for more than 100 people in Chicago. If those people had been able to go to work, every dollar that would have been spent would have returned $11.80 to the American economy.

This is not a tax loophole for the rich. It is an opportunity for people who have benefitted from the economy to take the things which reflect that benefit in the nature of their resources and to share them with people who have not had an opportunity to gain from our economy.

This proposal is supported by the administration. It has twice in the past been supported by this committee. The net result of it will be continued benefit to a sector that provides essential services.

We spent a lot of time this morning talking about jobs and how important they are. I have today more than 40,000 people on the payroll. At the end of this year, we will graduate a significant number of those people out into the competitive economy. If we are going to save jobs, we should work equally hard at creating them and creating them for the very populations which my organization serves.

This is a social service issue, not a museum issue, not a university issue, and I want to lay great stress on that and ask the committee's understanding in support of this effort.

Thank you very much.

[The prepared statement follows:]

STATEMENT
OF
REAR ADMIRAL DAVID M. COONEY, USN (RET.)
PRESIDENT AND CHIEF EXECUTIVE OFFICER
GOODWILL INDUSTRIES OF AMERICA, INC.
ON BEHALF OF THE
APPRECIATED PROPERTY WORKING GROUP

I am Admiral David M. Cooney, President and Chief Executive Officer of Goodwill Industries of America, Inc., the corporate office of the 172 Goodwill Industries operating throughout the United States and providing vocational rehabilitation services and employment for individuals with disabilities and other special needs. Last year, the Goodwill Industries network provided services to more than 126,000 individuals and placed an estimated 22,000 people into competitive jobs.

This statement is submitted on behalf of the members of the Appreciated Property Working Group, a coalition representing a broad range of charitable organizations including religious groups, colleges and universities, museums and arts groups, conservation and human service organizations like Goodwill industries. We are united in our support for the provision in the President's economic plan which would provide relief from the Alternative Minimum Tax for all gifts of appreciated property, I know that in the last Congress, a majority of this Committee supported this change. I thank you for your support and I would like to particularly thank Congressman Mike Andrews of Texas and Congressman Clay Shaw of Florida for their leadership this year.

Although we are perhaps best known for collecting and selling reusable goods, Goodwill Industries' primary mission is helping people realize financial independence so they may become self-reliant contributors to society. Revenues generated by our more than 1,300 retail stores finance our core activities--namely, providing vocational services such as skills evaluation, job training, and job placement. However, the demand for our services continues to increase and we are forced to look for other sources of support, including gifts of appreciated property. In this regard, I would like to emphasize three key points concerning the deductibility of gifts of appreciated property. In this regard, I would like to emphasize three key points concerning the deductibility of gifts of appreciated property.

First, it would be incorrect to characterize this issue as one affecting only museums and universities. Human services organizations such as Goodwill Industries are also recipients of gifts of appreciated property. Let me cite just one example:

- On a negative note, Goodwill Industries in Chicago in 1989 was offered a donation of appreciated real estate valued in excess of $250,000. However, the donor, upon consultation with his tax adviser, withdrew the offer because of the negative tax consequences that would have resulted. In this instance, a sizable donation that would have enabled Goodwill Industries of Chicago to expand services to individuals in need was not realized simply because of tax code disincentives that discourage donations of appreciated property.

Secondly, it would also be incorrect to characterize this issue as a loophole for wealthy Americans. It has been said that the difference between the rich and the poor is that the rich have money. In the continual search for resources, charitable organizations are forced to seek support where the money is and, oftentimes, that search leads to upper income individuals who may be subject to the AMT. However, the contributions to the public good realized from donations of appreciated property far surpass the social value received from imposing taxes on these gifts.

Finally, this panel and the full House and Senate in the past have recognized the importance of providing the relief now requested by President Clinton. The social ills facing the nations are all too readily apparent. We ask, simply, that the charitable sector be given the opportunity to marshall all available resources to maximize our efforts to solve these problems.

The available evidence indicates that the disincentives placed on gifts of appreciated property gifts has produced a dramatic drop in such donations from upper income taxpayers. Providing relief from the Alternative Minimum Tax for all appreciated property gifts will encourage donations to Goodwill Industries and other human services organizations at a time when demand for services far exceeds our available resources.

The disincentives to charitable giving in the tax code are exacerbated by declining federal support for nonprofit organizations. According to Independent Sector, an umbrella group for charitable organizations, nonprofit groups during Fiscal Years 1982 through 1991 lost $33.6 billion in federal support which would have been available had FY 1980 spending levels been maintained. Furthermore, while private giving increased during that time, it was able to offset only 46 percent of the shortfall in federal support. Many state and local governments have likewise been forced to make deep cuts in funding for critical human services.

Against this background of continuing need, America's charities call upon Congress to remove this impediment to charitable giving. As many of you are aware, this provision was included in the 1986 Tax Reform Act as part of an effort to strengthen the alternative minimum tax. The AMT is designed to ensure that all Americans pay their fair share in taxes. However, making gifts of appreciated property a tax preference item in the AMT has proved to be counterproductive. Donors, faced with the complexity of the AMT and uncertainty about its application to them, simply forego making their gifts. This thwarting of charitable intent cannot be what Congress intended in 1986.

On behalf of the charitable sector, and particularly on behalf of our nation's broad range of human service organizations, I thank you for this opportunity to testify. I strongly urge that the Committee provide AMT relief for gifts of appreciated property. Thank you, and I would be pleased to respond to questions you may have.

Mr. LEWIS. Thank you very much, Admiral.
Mr. Losey.

STATEMENT OF MICHAEL R. LOSEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SOCIETY FOR HUMAN RESOURCE MANAGEMENT, ON BEHALF OF THE SECTION 127 COALITION

Mr. LOSEY. My name is Michael Losey. I am president and CEO of SHRM the Society for Human Resource Management. SHRM is the leading voice of the human resource profession, representing the interests of more than 50,000 human resource practitioners and students in over 435 chapters in all 50 States. The work force represented by our membership is about 80 million.

On behalf of SHRM and especially the Section 127 Coalition, we want to thank the committee for the opportunity to come here and support President Clinton's proposal to reinstate and make permanent section 127 of the Internal Revenue Code.

It is the human resource practitioner's responsibility to recruit and train and retain an effective work force. In that role, our members hear directly from management and employees about which programs work. Since our members also administer these programs, we feel that we are uniquely positioned to give balanced input on this very important issue. That is why we're delighted to see that President Clinton included a permanent extension of section 127, employee educational assistance, in his economic stimulus and deficit reduction package.

And SHRM is not the only group pleased with this action. SHRM is the business cochair of the Section 127 Coalition, is a broad-based coalition, and it includes very diverse groups such as the U.S. Chamber of Commerce, the National Association of Manufacturers, the Association of American Universities, and the AFL–CIO and its member unions.

In this day of cliches and exaggerated claims of success, almost every idea is exalted as a win/win proposition. Section 127 is the real thing. It is a win because it represents a solid investment for our Government. Again, as President Clinton said, although there is a short-term cost, it is small, and this type of investment in human capital—and I quote the President—"promises payoffs for the Nation far beyond the original price."

It is a win because it represents solid investment for businesses, and, as you know, businesses just do not give money away. Business provides educational assistance because it helps them attract, helps them keep, and helps them motivate and promote professional development with their staffs. That is why temporary extensions of 127 have been so totally unsatisfactory and burdensome, with payroll people all over the country having to change automated systems at great cost and inconvenience to calculate manually corrections for tax documents of employees.

Now section 127 has expired once again. We need it back. Without 127, the Tax Code requires that all training be specifically related to the employee's job. This can operate to the disadvantage of lower income workers and especially those in lower skilled jobs who want to break out.

Section 127, on the other hand, gives employees a chance to get training for jobs they do not currently have but aspire to have. I

need look no further than my own family situation to see what a difference this type of additional assistance can make.

My sister was initially employed as a secretary for the Ford Motor Co. She knew a degree was necessary to get ahead, and I can remember her working all day long, going to school at night and on Saturdays and studying. Thirteen years she went to get her bachelor's and her master's degree. Her company stood by her side, provided an important incentive, and today she is a highly valued human resource professional at Ford.

Yes, employee educational assistance was a win for my sister. But more importantly, it is an unparalleled opportunity for the whole Nation. We are in fierce competition—we all know that—with other countries around this world. We simply cannot afford to not train our workers. We have an olympic struggle going on here. We need our own dream team that is being molded between the interests of Government, labor, higher education, employees, and employers, and we think we can literally and figuratively bring home the gold.

On behalf of all of us who share this interest, again thank you for the opportunity to make our presentation. We hope that you will call on SHRM and the Section 127 Coalition for additional assistance on this important matter.

Thank you, sir.

[The prepared statement follows:]

STATEMENT OF MICHAEL R. LOSEY, PRESIDENT AND CEO, SOCIETY FOR HUMAN RESOURCE MANAGEMENT

Mr. Chairman, my name is Michael Losey, and I am the President and C.E.O. of SHRM, the Society for Human Resource Management.

SHRM is the leading voice of the human resource profession, representing the interests of more than 50,000 professional and student members in 435 chapters from all 50 states.

On behalf of SHRM and the Section 127 Coalition, I wanted to thank you for the opportunity to come before the Committee to express our support of President Clinton's proposal to reinstate and make permanent Section 127 of the Internal Revenue Code.

SHRM members work for organizations employing over 80 million American workers. SHRM, however, has no corporate members-- only individuals. This protects the independence of our human resource professionals and allows them to continue in the role of being effective liaisons between employers and employees.

In the human resource professional's work to recruit, train and retain employees, we hear directly from both management and staff which programs work. Since we also administer those programs, SHRM members are uniquely positioned to give balanced input on which are the best and most effective policies in the workplace.

That is why we were delighted to see President Clinton include a permanent extension of Section 127, employee educational assistance, in his economic stimulus and deficit reduction package. And SHRM was not the only group pleased with this action. Section 127 is supported by a broad-based coalition of the business community, higher education and organized labor, including such diverse groups as the National Association of Manufacturers, the U.S. Chamber of Commerce, the Association of American Universities and the AFL-CIO.

I would also like to thank Congressmen Levin and Grandy of the Committee for their initiative in introducing H.R. 127, independent legislation that would also permanently extend Section 127. We appreciate their work and the support of many other members of this Committee who have cosponsored this bill.

In this day of cliches and exaggerated claims of success, every idea is exalted as a "win-win" proposition. Section 127 is the real thing, and I'll tell you why.

Section 127 is a **win** because it represents a solid investment for the government. As President Clinton himself has said, although there is a small, short-term cost, this type of investment in human capital "...promises payoffs for the nation far beyond the original price."

The Bureau of the Census tells us what we already know when it reports that education is the key to higher income. On average, employees with four or more years of college earn 70 percent more than employees with just a high school degree. Workers with greater income, in turn, have increased tax liability, with the government more than recouping its investment over the trained worker's lifetime.

Section 127 is a **win** because it represents a solid investment for business. Businesses don't just give away money. We provide educational assistance because it helps us attract good workers, keep them, and help them become even more productive employees. Section 127 is a **win** because it represents an unparalleled opportunity for employees. It empowers workers. It gives them a chance to broaden their expertise in many areas, beyond typical work-based training.

And that is why temporary extensions of Section 127 have been unsatisfactory. First, in response to the expiration and retroactive extension of Section 127, our payroll people have to change their automated payroll systems.

As David Sebolsky stated for the American Society of Payroll Management, "To change education assistance from taxable to non-taxable, all the entries made on the former status must be reversed..." "The employer may refund the withheld employee social security and Medicare or it may notify the employee of the amount, which may be recovered later on the individual tax return. The employer's matching contribution for social security and Medicare cannot be recovered by the employer under regulations. In almost every case, these adjustments must be made manually, a time-consuming and inefficient undertaking."

The temporary extensions also bring about the administrative headaches of not being able to make long range plans for training. True, there is another Code Section, Section 162, that allows for exclusion of strictly job-related assistance. But business cannot comply with a standard that requires us to guess whether IRS will consider it job-related every time we send a worker for training.

Although it hurts business, the loss of Section 127 is even worse for two groups-- current employees and laid off workers. The requirement that training be job-related can operate to the disadvantage of our low-income workers, relegating them to low-income type training.

Laid off employees, in turn, often have the shock of the job loss somewhat lessened by getting their former company to pay for training for other jobs available in the community. Without Section 127, these laid off employees would be taxed on that training at the very time they have no income and desperately need help in securing another job.

With Section 127, on the other hand, our workers have a chance to broaden their education, and prepare for the higher skilled jobs they **currently don't** have, but will ultimately qualify for. Section 127 can thus be the difference between <u>learning</u> "job-related" typing and dictation skills, and <u>earning</u> a degree that furthers your career.

I need look no further than my own family to cite examples of what a difference this type of educational assistance can make. My sister was initially employed as a secretary for Ford Motor Company. A degree was necessary for her advancement. I remember her going to school at night and on weekends. In total, she took university courses for 13 years. She was fully supported by her employer, and in time she earned her bachelor's degree and a master's in personnel management. Today she is a highly-valued human resource professional at Ford.

Employee educational assistance was a win for my sister, but it actually represents an unparalleled opportunity for the whole nation. We are in a fierce competition with other countries of the world, and our economic prosperity is at stake.

We simply cannot hope to keep up without training our workers. To get ahead in this "Olympic" struggle, we need the "dream team" that Section 127 puts together-- government, labor, higher education, employers and employees-- a group that will help us literally and figuratively "bring home the gold."

On behalf of all of us who share an interest in training and educating workers, I thank the Committee for its time today, and I hope that you will call on SHRM, the Society for Human Resource Management, if we can be of further help in restoring and permanently extending the exclusion for employee educational assistance.

Mr. LEWIS. Thank you very much, Mr. Losey.

As you well know, we had a dream team in Atlanta that brought home the Olympics for 1996. I think the President is trying to get us to bring home some gold with his fiscal proposal.

Mr. Hurley, let me just ask you, sir: As you know, the Treasury Department believes that some types of expenses are inherently personal in nature and that such expenses should not be deductible. Assuming that there is some element of personal pleasure associated with club membership and activities, how would you suggest we treat such expenses?

Mr. HURLEY. Well, Mr. Chairman, I believe that the requirements for documentation are adequate and applied rigorously by the IRS. If we are suggesting that simply because the location may have an atmosphere of very pleasant living, I do not know that I can address that particular question, other than to say that the taxpayer in question, in order to have a deductible expense, must be pursuing a business objective and so demonstrate. And as such, if that is the investment that he or she is making, then that ought to be deductible no matter where it is, even if it were taking place in one's home, which as we know, is certainly deductible, or it could be in a restaurant or in the Rockville restaurant that was described earlier today.

No matter where it is, I believe it is the intention of the taxpayer which is compelling here, not the location of where the expense takes place.

Mr. LEWIS. Thank you. Mr. Hurley, on page 2 of your prepared testimony, I was struck by your reference to the number of minorities and women who would be hurt if club dues are made nondeductible.

I am, just for my own information, I am curious to know whether you can tell the committee how many minorities and women—how many minorities and women are members of these clubs?

Mr. HURLEY. I am sorry, Mr. Chairman. I am not able to tell you that. But I can tell you, as someone who has been in this position almost 19 years, that I have seen an enormous change in the culture of this country and in the policies of our member clubs, and I will say partly stimulated by our own suggestion to all of these clubs that they operate their admission policies on individual characteristics such as congeniality, reputation, et cetera.

All of those clubs, to my knowledge, with rare exception, have made appropriate changes not only in their documentation of their policies, but actively in their profile and in their openness to membership.

That is the best I can tell you, other than to tell you that it is a very strong move. It is actively taking place. And I tell you that from personal observation.

Mr. LEWIS. Do you have a policy or a program to speed up the admission of minorities, women, and different religious groups and——

Mr. HURLEY. Yes.

Mr. LEWIS [continuing]. Ethnic groups to these clubs?

Mr. HURLEY. Well, in dealing with our clubs, all of these virtually are individual units, of course. Our policy is to stimulate the

idea that says you are evaluating people on their individual characteristics.

In terms of the city club situation—and a lot of this depends upon how people come to a particular club as individuals, as employees, whatever—that in the city club situation, particularly on the gender question, that has been settled for many, many years.

I would say the rest of the question about minorities is equally settled at the conceptual level. It is only a matter of the proper introduction and the demonstration by individuals of their interest in such clubs.

Mr. LEWIS. But you would agree with me that if the Federal Government provides for a tax writeoff or, if you want to call it a deductible expense, then we are in the business of subsidizing the discrimination against women and minorities or someone who may be a member of some other religious group?

Mr. HURLEY. If you would permit me, Mr. Chairman, I would first argue with the question about subsidy, because I feel these are legitimate business expenditures or they should not be taken, and that this is not something any more than salaries or anything else that the Government is underwriting, if you will.

As to whether or not the Government ought to be in that business, again I understand the nature of the question and the sensitivity to it. I would suggest, however, that the particular activity itself is what should be compelling. If it is the feeling of the Government, if the feeling is so strong in the connection between the two, then I suspect that something could be worked out whereby these things are restricted to those clubs—or denied to those clubs which discriminate, which is on the reverse side, in my view.

Most clubs in this country would pass your muster.

Mr. LEWIS. Thank you.

Admiral let me just ask you, sir: Do you think there are adequate safeguards in the Tax Code to guard against taxpayers who have paid one thing for a piece of donated property, or they tell you the value is at one price when it is something much less; what procedures does Goodwill Industries follow in this regard?

Admiral COONEY. Well, the law is specific in this respect, and there are some safeguards built into the pending legislation which would require a receipt be issued by the agency receiving any object which is valued at $750 or more, an actual written receipt which describes the object.

The second, which is already in force in the law, that any item which is valued at $5,000 or more must be evaluated by an independent expert on the subject, not by the agency receiving the gift or by the donor himself.

And, of course, the types of items that would mainly be covered by this would be in the $5,000-or-up category. I think that each of those will decrease any opportunity for cheating on such a thing. And, of course, most of the items that we are talking about that have real value have a given market price, like a share of stock or a group of bonds or a painting or something of that nature.

And, of course, sir, the truth—as far as Goodwill Industries is concerned, we convert everything to cash, and it is the actual conversion of cash which sets the market value upon which that person would make a deduction. We are not interested in being the

owners of stocks and bonds and Renoir paintings; we are interested in money which we can convert into buildings and job opportunities.

Mr. LEWIS. Thank you very much.

Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

I would like to just briefly go to the question of appreciated property contributions.

Mr. Cooney, I was reading in your testimony when you said that it is incorrect to characterize this issue as a loophole for wealthy Americans. And it is certainly not a loophole; it is an incentive to give, just as the charitable deduction from income tax itself.

Admiral COONEY. That was exactly my statement, sir. I agree with you.

Mr. SHAW. That it is an incentive to give. I have seen in many, many situations where people would like to go ahead and give appreciated property, if they can get a tax deduction. And this goes a long way toward supporting not only hospitals, but also museums, the cultural things in life, which are most important. These are—and I am speaking now of your museums and cultural type of things, your orchestras and things of that nature, as well as certainly the Goodwill—largely supported by the wealthy individuals.

But the recipients mainly are people who otherwise could not afford the exposure to the arts, the exposure to various things. And, in the case of Goodwill, the necessities of life, which are, of course, more important if you are without anything.

But I think that what we need to do is to continue in every way we can to provide those incentives for the wealthier Americans to be generous to those who are less wealthy and to assist as much as they can in performing these things.

In the area of the arts right now, it is controversial whether it is a proper expenditure to have the National Endowment for the Arts. Well, I strongly believe that there is a Federal involvement, even though I come down on the very conservative side of most issues. I think there is certainly nothing wrong with the Federal Government, in part, supporting the arts. But the major part of the support must come, and does come, and should continue to come, from private individuals and the generosity of those that life has been good to materially. We should encourage them to share their material wealth with the rest of the community.

I would very much like to see us return to the pre-1986 law in this regard. There has been a tremendous falloff in giving. A lot of people now are waiting to give. They say I would rather give now than wait until I die and do it in my estate. They find that their real incentives to do that are being taken away from them.

When you give money that you would lose, the appreciated assets are appreciated in the estate anyway. And I think it is best to go ahead and allow these types of deductions and recognizing that many of the things that you and the Goodwill, as well as the cultural facilities throughout the country, and hospitals, are really paying for are things that really would have to be paid for entirely by the Federal Government, if it were not for this generosity.

I think that we have to get away from the mentality that there is something in it for the wealthy and get to the mentality of con-

sidering the total good of the community. That is what we really need to talk about, whether we are talking about job creation, whether we are talking about charitable giving, or whatever we are talking about. If it is better for the entire community, then it should be part of the tax law. The dollar figure involved in this is not astronomical, and I would certainly support going back to the pre-1986 law in that area.

Admiral COONEY. Well, may I reinforce your views with——

Mr. SHAW. Any time.

Admiral COONEY [continuing]. With two quick illustrations?

In the first place, in my particular industry, we get very little Government money, and what we get we earn by providing services for a fee on which we always lose money, I must add here. But if you take a Federal dollar set aside for vocational rehabilitation and trace it through the sending system, 80 cents comes out of the Federal budget; 20 cents is matched by the States; and before it reaches the vocational rehabilitation facility where it is then applied to the training of the client, it is reduced to a range of 50 to 70 cents, whereas the dollar that comes directly to us is spent as a dollar.

And therefore dollars which are untaxed, but come directly to the target requiring the services, are much better used, and we get a much better turnaround.

The second thing is that fortunately in Goodwill we do very little raising of cash. We collect things, as you know, and that is why we are particularly interested in this.

But there is nothing more disillusioning than working with someone of wealth and substance, who also is highly motivated by social conscience and awareness of the problems of the particular community in which that individual lives, who becomes generally motivated to give of treasure and time and then encounters the blockage of dealing with the bureaucracy whereby he comes to the conclusion that he is being punished for having succeeded and being punished for wishing to be generous.

And we not only then lose the actual gift of the moment; we lose the whole attitude of support of that individual. And that is something that I cannot put a price on, but which is devastating to us. And the American penchant to give and volunteer is one of the essential characteristics of our society, and I do not want to see it eroded casually and carelessly by improper legislation.

And that is one of the reasons I am before you today, and I really appreciate your support.

Mr. LEWIS. Thank you. Mr. Shaw.

Mr. Santorum.

Mr. SANTORUM. No questions, Mr. Chairman.

Mr. LEWIS. Thank you.

Let me thank the members of this panel for being here, and your statements, your full statements, will be made part of the record. Thank you very much.

Will the next panel come forth?

Dawn Erlandson, director of tax policy, Friends of the Earth; Nancy Campbell, National Women's Law Center, copresident.

Thank you very much for being here. You may proceed.

STATEMENT OF DAWN ERLANDSON, DIRECTOR OF TAX POLICY, FRIENDS OF THE EARTH, ALSO ON BEHALF OF THE ENVIRONMENTAL AND ENERGY STUDY INSTITUTE

Ms. ERLANDSON. Thank you, Mr. Lewis, Mr. Santorum, and Mr. Shaw, good afternoon.

I am Dawn Erlandson, director of tax policy for Friends of the Earth. We are a global environmental advocacy organization with affiliates in 50 other countries. My statement this afternoon is made on behalf of Friends of the Earth and the Environmental and Energy Study Institute.

I thank you for the opportunity to appear before the committee to express our support for the President's economic package and, in particular, those pieces that foster environmental protection. In addition, I would like to thank the committee for its work last year in advancing a package of environmentally sound tax provisions as part of the energy bill, and I look forward to working with you again this year.

The President has laid before the Congress and the American people a bold plan that recognizes that environmental protection is good for the economy. Integral to his plan is a broad-based energy tax that will not only reduce the deficit, but also combat pollution. With it, he sends an important signal of leadership to the international community that the United States is serious about reducing its emissions of greenhouse gases. With it, he provides a way to achieve deficit reduction that taxes things we want to discourage, pollution and inefficiency, rather than things we want to encourage, work, savings, and investment.

To honor his commitment to tax fairness and progressivity, he proposed substantial increases in the earned income tax credit, food stamps, and the low-income home energy assistance program to offset the impact of the tax on lower-income energy consumers.

These provisions are critical components of the package, and we would oppose strongly any reductions in them. The proposed tax was delicately crafted to be regionally fair, to properly encourage greater reliance on cleaner energy sources, and to induce energy efficiency in the economy.

While those of us who care about environmental protection would have preferred a heftier tax that relied on a pollution criteria, we have agreed to work with the President on his proposal. Others, however, have lined up against the tax and are seeking to thwart its goals through exemptions and other special treatment.

We urge the committee to reject such efforts and to preserve the important objectives of the tax as proposed. Specifically, we urge the committee to reject attempts to replace the tax with a broad-based consumption tax or an ad valorem tax, neither of which would lead to the environmental gains of the proposed Btu tax.

We urge you to reject proposals to move the point of collection closer to the consumer or to exempt energy consumed in the process of producing energy or in the process of making basic materials such as aluminum and steel. All such proposals would result in lost efficiency throughout the production process, as well as lost revenue.

We urge you to reject attempts to exempt or lower the tax rate for hydro power and alternative fuels, such as ethanol. These en-

ergy sources are not environmentally sound, nor are they emerging technologies that need tax relief. It is important to keep in mind that, even with the proposed Btu tax in effect, prices for all types of energy paid in the United States by businesses will remain well below corresponding prices paid by their European and Japanese competitors.

A number of other provisions proposed by the President are also important for the environment. Among them is the proposal to raise the fuel tax on commercial inland waterway users to $1.20 per gallon in 1977. Commercial waterway traffic causes substantial damage to natural resources through the dredging and dumping required to keep the waterways clear.

In 1990, the Federal Government spent $776 million to build, operate, and maintain the Nation's inland waterway system for navigation purposes. By contrast, the fuel tax raised only $63 million, or less than one-sixth of the Federal cost, just to operate the system.

Let me just add a couple more points. I see that my time is up.

We do support the extension of the existing motor fuels tax of 2½ cents per gallon that is scheduled to expire and urge you to at least use 20 percent of the revenues for mass transit. We support the President's proposal to provide that gifts of appreciated property, such as land, not be treated as preference items under the alternative minimum tax.

We support the administration's proposal to exempt private activity bonds, to provide high-speed rail facilities from State private activity bond volume limitations.

Finally, we encourage the committee to consider enhancing the energy and environmental tax changes adopted as part of the energy bill last year. Thus, we urge you to expand the tax on ozone-depleting chemicals to cover methyl bromide, HCFC's, and HBFC's. These chemicals were listed as controlled substances under the Montreal Protocol last fall, and in the past, all chemicals that have been listed under the protocol were taxed.

We ask the committee to provide full income tax exemption for energy efficiency rebates and allow utilities to expense efficiency investments.

We urge you to consider providing AMT relief for the renewable energy industry, so that they can take advantage of the investment and production tax credits provided last year.

Thank you.

[The prepared statement follows:]

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Statement of

Dawn Erlandson
Director of Tax Policy
Friends of the Earth

On Behalf of

Friends of the Earth
Environmental and Energy Study Institute

Regarding

President Clinton's Proposals for Public Investment and Deficit Reduction

Before the

Committee on Ways and Means
United States House of Representatives

March 31, 1993

INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I am Dawn Erlandson, Director of Tax Policy for Friends of the Earth (FoE). We are a global environmental advocacy organization with affiliates in 50 other countries. My statement this morning is made on behalf of Friends of the Earth and the Environmental and Energy Study Institute and our members and supporters.

Mr. Chairman, I thank you for the opportunity to appear before the Committee to express our enthusiastic support for the President's economic package and, in particular, those pieces that foster environmental protection, some of which are in the jurisdiction of this committee.

At this time last year, I appeared before the Committee to urge adoption of a package of environmentally sound tax proposals as part of energy legislation moving through the Committee. Thanks to the leadership of Chairman Rostenkowski, Congressmen Stark, McDermott, Matsui and others, the bulk of those proposals were adopted by the Committee and became law as part of the Energy Policy Act of 1992.

Now, our new President has laid before the Congress and this Committee an historic plan that embraces the idea that environmental protection is good for the economy. Included in this plan to reduce the deficit and invest in our future are a number of environmentally-minded tax proposals. We urge the Committee to embrace these proposals as it has similar proposals in the past and to put the interests of the public ahead of those of the special interests.

PRESIDENT'S ECONOMIC PACKAGE

On February 17, the heads of eight major environmental groups issued a joint statement on behalf of over 2 million members pledging their active support for the President's plan. They said,

> "The President's proposal hits many of the country's most powerful special interests -- like oil, coal, and timber companies -- where it hurts. The package is one that the special interests will love to hate. They will pull out all the stops to kill the package in Congress. We urge Congress to ignore their pleas and to endorse the President's proposal."

The President's proposal marries a package of spending cuts, tax changes, and investment proposals when taken as a whole are progressive and fair. It presents a plan for a healthy economy <u>and</u> a healthy environment.

<u>BTU Tax</u>

Integral to this plan is a broad-based energy tax. The proposed tax would provide a critical step toward an efficient economy, a clean environment and a sustainable energy future if enacted. As the President declared in his State of the Union address, the proposed energy tax "combats air pollution, promotes energy efficiency, promotes the independence economically of this country, as well as help[s] to reduce the debt." As my colleague, Dan Lashof of the Natural Resources Defense Council, testified before the Committee last Tuesday, the BTU tax will do "double duty" fighting pollution as well as the deficit.

Sending an important signal of leadership to the international community, this tax proposal marks the first real step toward reducing our nation's emissions of greenhouse gases that threaten the stability of the world's climate. In addition, it provides a way to achieve deficit reduction that taxes "bads"--pollution and inefficiency--rather than "goods"-- people's incomes, savings, and investments.

To honor his commitment to tax fairness and progressivity, the President included a number of provisions in his package to offset the impact of the tax on lower-income energy consumers. Specifically, he proposed substantial increases in the Earned Income Tax Credit (EITC), Food Stamps, and the Low-Income Home Energy Assistance Program (LIHEAP). We believe these provisions are critical components of the package and would strongly oppose reductions in them. We urge the Committee to adopt the expansion of the EITC as both a reward for work and an offset for increased energy expenses. In addition, the President's proposal increases funding for weatherization programs which would actually allow low-income households to come out ahead financially even while we all benefit environmentally.

The proposed tax was delicately crafted to be regionally fair, to properly encourage greater reliance on cleaner energy sources, and to induce energy efficiency in the economy. While those who care about environmental protection would have preferred a heftier tax based on pollution criteria, we have agreed to work with the President on his proposal. Others have lined up against the tax and are seeking to thwart its goals through exemptions and other special treatment. We urge the Committee to reject such efforts and preserve the important objectives of the tax as proposed.

Specifically, we are concerned about attempts to replace the tax with a broad-based consumption tax or an ad valorem tax, neither of which would lead to the environmental gains of the proposed BTU tax. A value added tax would tax value added, or national income, precisely what we are trying to increase. "In order to improve living standards, we want national income to grow as fast as possible.

Economically, value added is a good thing...[and] the important components of value added, payroll and profits, are already taxed quite heavily." ("Comparing the Economic and Environmental Effects of Value-added and Broad-based Energy Taxes," World Resources Institute, February 24, 1993.) Conversely, an energy tax taxes pollution and inefficiency, things we want to discourage.

An ad valorem tax would have the perverse effect of aggravating price fluctuations and, if imposed at the wholesale level, could in later years cause fuel switching from natural gas to coal. An ad valorem tax imposed at the retail level would tax the embedded cost of capital in power plants and transmission lines and would eliminate any incentive for utilities to become more energy efficient in power generation. An inefficient utility with high fuel costs and low capital costs would have the same tax liability as a highly efficient plant with low fuel costs but higher capital costs. (Testimony before House Ways and Means, Daniel Lashof, March 23, 1993.)

Efforts to move the point of collection closer to the consumer and exempt particular energy sources should be rejected. The closer the tax is collected to its original production (e.g. wellhead, minemouth), the greater the energy efficiency throughout the production process. Inequities with imported products should be addressed with appropriate tax rates on imports rather than elimination of taxes on energy consumed in the refinery process or in the pipeline.

All energy consumed in the economy should be taxed except for emerging, clean, renewable energy sources such as wind and solar and potential energy sources that are otherwise pollutants such as methane extracted from coal seams during mining. Oil used in the production of oil should be taxed just as coal used in the production of electricity should be taxed. Likewise, energy used in the production of aluminum, steel, and other materials should be taxed. A rebate should be provided for that portion of the energy source that chemically becomes a part of the finished product, such as a portion of the carbon from metallurgical coal in the production of steel.

Efforts to exempt from the tax or reduce the rate of tax for alternative fuels (ethanol, methanol, CNG) and hydropower should be rejected. Ethanol, for example, is already heavily subsidized, and its current production from corn and sugar can be extremely damaging environmentally. Hydropower, while emitting no air pollutants, has adverse environmental effects including serious declines in fisheries, species diversity, riparian habitat, and water quality in rivers across the country. Alterations in the tax level on hydropower would result in a serious disruption of the regional balance now presented by the proposed BTU tax.

As for the competitiveness arguments put forward by a number of industry groups, it is important to emphasize again the points made by my colleague, Daniel Lashof, before the Committee last week. Even with the proposed BTU tax in full effect, prices for <u>all types</u> of energy paid by U.S. businesses will remain well below corresponding prices paid by their European and Japanese competitors. Contrary to agruments by industry before this committee, other OECD countries do tax energy sources besides motor fuels. For example, Germany taxes oil of all kinds as well as electricity and natural gas used for electricity. Japan taxes steam coal, oil, natural gas, and electricity.

After all the details are debated with regard to this tax, it is important to remember that all users of energy, whether basic industries or homeowners, can avoid the incidence of the tax by making investments in insulation and energy efficiency or switching to cleaner forms of energy and thus leave our economy and environment healthier.

Inland Waterways Fuel Tax

A number of other provisions proposed by the President are also important for the environment. Among them is the proposal to raise the fuel tax on commercial inland waterway users to $1.20 per gallon in 1997. Commercial waterway traffic causes substantial damage to natural resources through the dredging and dumping required to keep the waterways clear.

Until 1980, users of the inland waterway system paid nothing for the enormous benefits they received. Taxpayers shouldered the entire cost of construction, operations, and maintenance of the nation's inland waterway system for commercial navigation. In 1980, an excise tax was imposed on the use of fuel in commercial waterway transportation pursuant to the Inland Waterways Revenue Act of 1978. In 1986, the rate was increased through the Water Resources Development Act which mandated that users pay 50 percent of the costs for new project construction. Under the law, money from the tax goes into the Inland Waterway Trust Fund which covers the remaining 50 percent of new project costs. However, the users of the inland waterway system have yet to begin bearing their fair share.

In 1990, the federal government spent $776 million to build, operate, and maintain the nation's inland waterway system for navigation purposes, according to the Congressional Budget Office. About $384 million of this amount is spent on operations and maintenance of the system. By contrast, the fuel tax raised only $63 million in 1990, or less than one sixth of the federal costs just to operate the system. "The substantial imbalance between costs and user taxes, suggests that it is desirable to explore ways of placing a larger share of the burden on the users." ("Paying for Highways, Airways, and Waterways: How Can Users Be Charged?", Congressional Budget Office, May 1992, p. 53)

Because of the heavy federal subsidy of waterways, towing companies have been able to charge artificially low rates which do not reflect the costs of operating, maintaining, and constructing the inland waterway system. It is time that those who use our nation's rivers pay the costs of maintaining them.
The Office of Management and Budget estimates the tax will raise $820 million between 1994 and 1997.

Gasoline Tax

We support the extension of the existing motor fuels tax of 2½ cents per gallon that is scheduled to expire in 1995. Gasoline prices in the United States are not only far below those in other countries but also what they were in this country in 1960. The result of our reliance on cheap gasoline has been widespread urban air pollution, suburban sprawl that threatens important ecosystems, and increasing reliance on Middle Eastern oil imports.

We understand that the Administration will propose that the revenues from such a continuation be dedicated to infrastructure investments rather than deficit reduction as they were in 1990. The Administration will also recommend that 80 percent of these revenues go to the Highway Account of the Highway Trust Fund and 20 percent to the Mass Transit Account. This has been the historical dedication of revenues since 1982 when the Mass Transit Account was created. In addition, we believe this split is in keeping with the spirit of the Intermodal Surface Transportation Efficiency Act and with the Administration's support for transit and environmental protection.

We strongly encourage the Committee to ensure that at least 20 percent of the funds be dedicated to mass transit. Transit needs must be addressed and the benefits of transit investment fully recognized, including productivity gains resulting from congestion relief, attainment of air quality goals, improved energy conservation, and mobility for all citizens, especially the poor who rely on transit for access to jobs and health care.

Alternative Minimum Tax (AMT) and Land Conservation

We support the President's proposal to provide that gifts of appreciated property not be treated as preference items under the Alternative Minimum Tax (AMT). This change is particularly critical for the preservation of wildlife habitat, wetlands, woodlands, and open space.

Before the Tax Reform Act of 1986, contributions of property to charitable organizations could be claimed as tax deductions equal to the property's fair market value. Owners of natural areas and other critical open space could permanently protect their land for the benefit of the public by donating the property with a perpetual conservation easement on the property to the government or a nonprofit conservation organization. For such donations, they could generally claim a tax deduction equal to the property's fair market value.

Since the enactment of the Tax Reform Act of 1986, the donation of gifts of appreciated property has drastically been reduced. This is because the Tax Reform Act of 1986 changed the tax rules to include the appreciated portion of these gifts as tax preference items for the purpose of calculating the Alternative Minimum Tax. Currently, the amount taxpayers who pay AMT can deduct for appreciated property gifts is limited to the taxpayer's basis, or financial investment, in the property rather than its fair market value. The basis is typically far below the current fair market value because such property is often in the family for a very long time. Many owners of land available for conservation often are not wealthy and thus do not have the wherewithal to protect their land. As a result, many donations that could have been made before 1986 have not been made since then due to the tax rules. The result has been that ecologically important lands have not been donated for perpetual or worse have been lost to real estate developments.

Tax-exempt Bonds for High Speed Rail Development

We support the Administration's proposal to exempt private activity bonds to provide high-speed rail facilities from State private activity bond volume limitations. This change is important for the private development of a cleaner, more energy-efficient alternative to air and highway travel and can prevent the need to construct additional highways and airports, in such places as Boston and Chicago.

Current law requires that 25 percent of each bond issue for high-speed intercity rail facilities must receive an allocation from a State private activity bond volume limitation. Since most states are operating at or near their cap, the restriction effectively serves as a barrier to the use of tax-exempt bonds for high speed rail systems. This requirement has effectively prevented the private development of high speed rail systems in the United States. Given that governments at all levels are financially strapped, it is unlikely that these systems will be built solely with public funds.

This provision passed the Senate last year as part of H.R. 776, the Energy Policy Act, but was not included in conference agreement.

Investment Tax Credit and Passive Losses

We are concerned that the President's proposals to reinstate general Investment Tax Credits and to loosen the passive loss rules governing real estate investments may have negative environmental consequences. While we have no official position on these provisions at this time, we do want to raise the concerns that have been expressed in our community.

As you know, the general Investment Tax Credit was repealed in 1986. At that time, the environmental community supported its repeal due to the unnecessary incentive for the construction of coal and nuclear power plants. This concern still holds,

particularly for those utilities that are regulated monopolies. in which investments are made based solely on demand, not competition. Investments in new capacity need not and should not be encouraged.

The 1986 Tax Reform Act (TRA) also eliminated abusive tax shelters that existed in the real estate industry due to the use of passive losses in rental real estate to offset active income. The result of these changes was to cut back on real estate development. While the industry cites this result as a reason to return some of the tax advantages that existed before the 1986 TRA, those who care about ecologically sensitive areas such as beaches and coasts fear that the rapid development that preceded the change in 1986 could return and thus further threaten already sensitive areas.

ENHANCEMENT OF GREEN TAX PACKAGE IN THE ENERGY BILL

As mentioned in the opening remarks, the Energy Policy Act contained a number of important tax provisions to promote environmental protection, energy efficiency, and renewable energy sources. We urge the Committee to consider enhancing these important tax changes adopted last year. We believe these measures would complement the President's economic package and its goals of deficit reduction, investment, and environmental protection.

Ozone-depleting Chemicals Tax

One of the most popular taxes in recent years has been the tax on chemicals that deplete the ozone layer. This tax has not only proven to be a reliable revenue raiser but also an effective weapon in the international arsenal to combat ozone depletion and its causes.

The Committee has previously taxed all chemicals controlled by the international treaty that governs ozone-depleting substances, the Montreal Protocol. In addition, all chemicals categorized as Class I substances under the Clean Air Act are subject to the excise tax. Consequently, CFCs and halons were originally taxed and methyl chloroform and carbon tetrachloride were consequently taxed.

Last November, the parties to the Montreal Protocol including the U.S. listed methyl bromide, a highly toxic fumigant pesticide, as a controlled substance and agreed to freeze consumption at 1991 levels in 1995. The parties also listed HCFCs, bridge chemicals between CFCs and ozone-safe alternatives, and capped their use beginning in 1996 with reductions beginning in 2004. Finally, the Protocol listed HBFCs, fire-fighting chemicals, and, due to their high ODPs, agreed to phase them out by the beginning of 1996.

The Clean Air Act requires HCFC recycling, bans certain applications, and phases out production beginning in 2015. In addition, the EPA has proposed to list methyl bromide as a Class I substance and freeze production at 1991 levels by 1994 and phase out production by 2000. EPA has also proposed to list HBFCs as Class I substances and phase them out by 1996.

Accordingly, it is appropriate to expand the existing tax on ozone-depleting chemicals to methyl bromide, HCFCs, and HBFCs. Some of these chemicals have higher ozone depleting potentials than other chemicals that are already taxed.

We urge the Committee to adopt legislation soon to be offered by Congressman Stark to tax these chemicals.

Energy Efficiency and Renewables

Finally, we urge the Committee to provide full income tax exemption for energy efficiency rebates. The Energy Policy Act of 1992 provided a partial exemption for payments received from utility companies as energy efficiency rebates for commercial and industrial consumers. This should be expanded from 65 percent to 100 percent.

The Committee should consider allowing utilities to expense efficiency investments as has been proposed by Congressman McDermott, and should provide AMT relief for renewable energy industries in order that they can take advantage of the Investment and Production Tax Credits adopted last year.

Finally, we hope the Committee looks to further reductions below $155 per month in the amount of parking benefits that employers can provide to their employees tax free as a way not only to raise additional revenue but also to encourage environmentally superior alternatives such as mass transit and bicycling.

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Mr. LEWIS. Thank you very much, Ms. Erlandson.
Ms. Campbell.

STATEMENT OF NANCY DUFF CAMPBELL, COPRESIDENT, NATIONAL WOMEN'S LAW CENTER

Ms. CAMPBELL. Thank you, Mr. Chairman.

Let me start by saying that I am proud to be testifying today on the only all-women panel, even if there are only two of us, and I know that it is late in the day.

I would like to not read my testimony, if that is sufficient, but have it submitted for the record.

Mr. LEWIS. Without objection, it will be submitted and become part of the record.

Ms. CAMPBELL. Thank you.

I would like to talk a little bit about the issues that we address in our testimony. First of all, let me start by saying that we believe that women should pay their fair share of taxes, but because of their generally lower incomes, women do benefit from a tax system that is more progressive. Of course, we believe that all Americans benefit from such a system because it bases taxation on ability to pay, and that is critical.

For these reasons and because women and their families will benefit as well from the investment and deficit reduction provisions that are in the President's proposal, we support both the revenue measures, in general, of the President's proposal and the proposal overall, and I have attached to my testimony a statement of 24 women's organizations in support of the overall proposal.

With respect to the revenue measures, which is what my testimony addresses specifically, I want to talk about the individual and corporate tax provisions, the energy tax provisions, and the Social Security tax provisions.

In each of these instances, my testimony provides more detail than I will, of course, give in my summary. The personal income and corporate tax increases are perhaps the most progressive tax provisions in the package, and, as the administration estimate states, only about 5 percent of households have incomes over $100,000 and only 1 percent have incomes above $200,000, and most of these increases, including several of the ones we have talked about today, will essentially fall on these households.

Not only are very few men and women in these households, but particularly women who head households alone are a very small percentage of this group, and so we believe that not only is this a very progressive effort, but it also will impact very little on women who are trying to support families alone.

The energy tax, of course, will affect all women and families essentially, but here, too, the progressivity of the proposal has been protected by the three offsets that the President suggests to protect families with incomes under $30,000: the large increase in the earned income tax credit, the increase in food stamps, and the increase in the Low-income Home Energy Assistance Program.

Not only will these offsets help protect families under $30,000, but they are accomplished by increases in programs in which women are the primary beneficiaries. About 75 percent of the

households that get food stamps are households headed by women or women living alone, particularly elderly women.

It is also important that $30,000 was chosen as the approximate cutoff for the protection that is given against the energy tax. In 1991, the median household income in the United States was about $30,000. Obviously, that will go up by 1994, but still about half the households will be protected by these offsets, and for women, the protection is even more significant, particularly, again, women who head households alone.

I give in my testimony some more details on this, but, essentially, 70 percent of female-headed households are under $30,000, and over 80 percent of women living alone are under this income level.

With respect to Social Security, of course, the increase in taxation tips in at a fairly low level, the current level of $25,000 for singles and $32,000 for married couples. Even here, though, there is progressivity in that only about 23 percent of beneficiaries will be affected, and, as I give in more detail in my testimony, many more men than women will be subject to increased taxation by this—particularly important protection for women living alone.

Before closing, I would just like to draw attention to the last three parts of my testimony where I discuss some issues presented by the President's proposal and issues that are otherwise important to women that should be considered by the committee.

The first is to provide greater equity for heads of households in the Tax Code. The President's proposal spells out, for example, that the new 36 percent rate will start at around $115,000 in taxable income for singles and $140,000 for married couples, but does not say where it will start for heads of households. We urge the committee to make the beginning point for heads of households for the 36 percent rate and at lower tax rates, also, the same as for married couples because the situation of heads of household is much closer to married couples than to singles.

Of course, in 1986, the Tax Reform Act did try to provide greater equity for heads of household, but did not go completely to the point where heads of households are taxed the same as married couples, and we urge you to complete the 1986 revolution now, when we are looking at tax rates again.

The other two provisions, making the dependent care credit refundable and indexing it for inflation, are ones this committee has considered before and we urge you to consider again.

Finally, the last section of my testimony addresses some simplification provisions that are being looked at by the General Accounting Office and we understand are being introduced as legislation by Senator Moynihan and Senator Packwood in a bipartisan effort. We hope that this committee will join in that effort to make the code simpler for women and families.

Thank you very much.

[The prepared statement and attachments follow:]

STATEMENT OF NANCY DUFF CAMPBELL, CO-PRESIDENT, NATIONAL WOMEN'S LAW CENTER

Mr. Chairman, and members, of the Committee, the National Women's Law Center is a national women's legal organization that has been working for twenty years to protect and advance women's rights. We have long been involved in tax issues affecting women. We co-founded and for nearly 10 years have chaired the Coalition on Women and Taxes, which had its origins in the reform efforts that culminated in the Tax Reform Act of 1986 (TRA). We have testified before the Committee several times on tax issues and worked with Committee and subcommittee staffs to craft tax proposals beneficial to women and families. Most recently, we worked on the two revenue measures passed by Congress last year but vetoed by President Bush, as well as the tax changes contained in the 1990 and 1991 Reconciliation Acts.

We are pleased to have this opportunity to testify before the Committee today on the revenue provisions of President Clinton's proposal for public investment and deficit reduction. The focus of our testimony will be the impact of the provisions on women and families.

We support the President's proposed, and believe it has the potential to help women and their families significantly by addressing the human needs deficit, the investment deficit and the budget deficit. The human needs deficit has contributed significantly to the widespread poverty of women and children. The investment deficit has restricted education, training, and job opportunities, hampering the ability of women to support themselves and their families. The budget deficit has swallowed up private savings, leaving few resources to devote to human needs and human capital investments that will promote economic growth and help women and their families thrive and prosper. We have attached a statement that we authored, which has been endorsed by twenty-four women's organizations, explaining in more detail the reasons for our support of the overall plan.

With respect to the revenue measures of the President's proposal, our support is based on the fact that they are for the most part progressive, insulating low-income women and families from their adverse effects and placing the most burden on those households best able to bear it. In effect, low- and moderate-income households would experience no tax increases and middle-income households would experience only small increases. High-income households would experience the greatest increases but even these increases would, on average, leave the tax burden of these households lower than it was in the mid-1970s.

Our testimony will address 1) the personal income and corporate tax changes, 2) the energy tax, 3) the increased taxation of Social Security benefits, and 4) other tax changes that should be made by the Committee to increase tax equity for women and their families.

1. The Personal Income and Corporate Tax Changes

Over half of the revenue increases in the proposal would be attained by raising the taxes paid by high-income individuals. Over 70 percent of the revenue increases would be attained by raising the taxes paid by high-income individuals and corporations.

The provisions include:

♦ An increase in the top 31 percent tax rate to 36 percent for single filers with taxable incomes above $115,000 and joint filers with taxable incomes above $140,000. When the deductions and exemptions that are subtracted from adjusted gross income (AGI) to reach taxable income are taken into consideration, this increase would generally affect only single filers with adjusted gross incomes above $140,000 and joint filers with adjusted gross incomes above $180,000.

♦ A surtax of 10 percent on all individual income tax filers with taxable incomes above $250,000. In effect, these filers would have a 39.6 percent tax rate.

♦ A requirement that the Hospital Insurance (HI) portion of the Social Security payroll tax be paid on all earnings. Currently this tax is only paid on earnings up to $135,000; accordingly, this change would affect only individuals with earnings above this level, who would receive a 2.9% increase in the payroll tax on earnings above $135,000. The revenues gained would increase the HI Trust Fund, which is otherwise in danger of being exhausted by the turn of the century.

- An increase in the Alternative Minimum Tax (ATM) rate -- paid by high-income filers whose deductions and tax preferences would otherwise shield them from taxation -- from 24 percent to 26 percent on ATM income of less than $175,000 and 28 percent on ATM income over $175,000.

- A reduction in the compensation that can be taken into account for purposes of benefits and contributions under qualified retirement plans from $235,840 (in 1993) to $150,000.

- A reduction in the deduction for business meal and entertainment expenses from 80 percent of the expenses to 50 percent.

- Elimination of the deduction for private club dues.

- An increase in the corporate tax rate from 34 percent to 36 percent for taxable corporate income over $10 million. About one tenth of one percent of corporations would be affected by this increase in any one year.

- A prohibition on corporate deductions for executive salaries in excess of $1 million a year, unless such salaries are linked to productivity.

As is apparent, these tax increases will almost exclusively affect only the highest-income households. Only about five percent of households have incomes above $100,000, and only one percent have incomes above $200,000. Accordingly, most women -- and men -- will not be affected by these increases. This is particularly true for women who are the sole heads of their family's household -- barely .2 percent of all households have incomes over $100,000 and are, in Census Bureau parlance, "headed by a woman with no husband present" (hereinafter referred to as "sole-female-headed households") or are women living alone.

With respect to the corporate taxes in the President's proposal, they are for the most part targeted on larger, wealthier corporations, and are in any event relatively modest, particularly when viewed in combination with the business tax breaks that are also a part of the proposal.

Indeed, many small businesses -- where most women are employed and which are increasingly being launched by women -- will see a reduction in their taxes. Between 1982 and 1987 there was a 58 percent increase in the number of women-owned businesses, more than four times the increase in men-owned businesses. The overwhelming number of women-owned businesses are small businesses.

2. The Energy Tax

The new, broad-based tax on energy, based on the energy content of fuels measured in British thermal units (BTUs), will affect virtually all women and families. The Administration estimates the average household would pay about $200 more per year ($17 a month) because of the energy tax.

However, because of the regressive nature of the energy tax, the President's proposal includes three provisions to offset its effect on low- and moderate-income households. The first is a large increase in the Earned Income Tax Credit (EIC) of over $6 billion a year; the second is an increase in Food Stamp benefits of $1 billion in FY 1994, $2 billion in FY 1995 and $3 billion in years thereafter; and the third is an increase in the Low-Income Home Energy Assistance Program (LIHEAP) of $1 billion by FY 1997. Taken together, these three provisions offset the energy tax and protect against an overall reduction in income for households with incomes below $30,000.

These three offsets are a critical part of the President's proposal. The proposed expansion of the Earned Income Credit is particularly significant. Currently the EIC covers families with children and earnings below approximately $24,000 for 1994. The President's proposal would increase the credit amount and eligibility for the EIC for families with children to approximately $30,000. In addition, singles and childless couples would for the first time be eligible for the EIC. These changes, in combination with the Food Stamp and LIHEAP changes that would help low-income families who do not get the EIC because they do not meet the

earnings test would protect many families, elderly and disabled individuals from the effect of the energy tax.[1] In addition, in some cases, they would help these families combat their poverty by actually increasing their disposable income.

The protection that the President's proposal provides to households with incomes below $30,000 is significant. As of 1991, median household income in the United States was $30,126. Even with the increase in median income expected by 1994, nearly half of all households will have incomes below $30,000. For women, the protection is even more significant. The median income of sole-female-headed households was $17,961 in 1991; the median income of women living alone was $12,834. Indeed, 63 percent of sole-female-headed households had incomes below $25,000 in 1991; 77 percent had incomes below $35,000.[2] Seventy-seven percent of women living alone had incomes below $25,000 in 1991; 88 percent had incomes below $35,000.

Women's generally lower incomes provide them a measure of protection from the modest tax increases for households in the $30,000-50,000 income range as well. Only 27 percent of sole-female-headed households (3 percent of all households) had 1991 income in the $25,000-$50,000 range; only 19 percent of women living alone (less than 3 percent of all households) had incomes in the 25,000-50,000 range.

3. The Increased Taxation of Social Security Benefits

Although counted as an entitlement cut in the budget, the President's proposal to subject a greater portion of Social Security benefits to taxation merits discussion as a revenue measure as well. We support this proposal, because it is progressive in nature and because it provides needed revenues to the Social Security trust fund.

Currently, 50 percent of Social Security benefits are counted as taxable income for single beneficiaries with incomes above $25,000 and married beneficiaries with incomes above $32,000. (Beneficiaries with incomes below these levels are not taxed on any portion of their benefits.) The Administration's proposal would increase the 50 percent to 85 percent. This would render the tax treatment of Social Security benefits, for those filers subject to taxation, roughly comparable to the tax treatment of public and private pensions, which are taxed to the extent they exceed employee contributions. Current estimates are that only about 15 percent of Social Security benefits received are attributable to the contributions employees have already made to the system.

The increase in the taxation of Social Security benefits would in 1994 affect only about 23 percent of beneficiaries. Women who are the sole support of their households are less affected than similarly situated men. In 1990, only 21 percent of nonmarried women beneficiaries age 65 or older had incomes above 25,000, compared to 27 percent of nonmarried men beneficiaries of the same age. Although the percentage of Social Security beneficiaries affected by the taxation of benefits will increase over time -- because the income levels are not indexed for inflation -- women will not be affected by this as much as men because of their generally lower incomes.

4. Other Tax Changes the Committee Should Adopt As Part of the Final Proposal

Several additional tax changes are consistent with the President's proposal to make the tax code more progressive and would increase tax equity for women and families.

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[1] Women and their families are currently significant beneficiaries of the EIC, Food Stamps and LIHEAP. For example, as of mid-1990, nearly 60 percent of Food Stamp beneficiaries were female. Single female adults, female-headed households with children and female-headed households without children constitute 75 percent of all households participating in the Food Stamp program.

[2] The Census Bureau provides income breaks at $25,000 and $35,000 but not $30,000.

- **Providing Greater Tax Equity for Head of Household Filers**

The President's proposal provides details of the effect of its tax rate increases on single individuals and married couples filing jointly but not on heads of household. Thus, the proposal states that the new 36 percent tax rate takes effect for single filers at taxable incomes above $115,000 and for joint filers at taxable incomes above $140,000 but is silent with respect to heads of household. We urge the Committee to set the income level at which the 36 percent rate begins for heads of household at $140,000 and, at the same time, to complete the effort begun in the Tax Reform Act of 1986 to afford heads of household the same tax treatment as married couples filing jointly.

Prior to 1986, heads of household were treated like single individuals without dependents, despite an ability to pay taxes that is comparable to married-couple families. Although the Bureau of Labor Statistics had demonstrated that the household expenses of a family maintained by a single parent is very close to, if not greater than, the expenses of a married-couple family of the same size, a head of household with two children and $10,000 in AGI in 1986 paid 37 percent more tax than a married couple with one child and the same income.

This inequity in tax policy was caused primarily by the law's failure to provide a standard deduction for heads of household equal to the standard deduction for married couples. Instead, prior to the TRA heads of household had the same standard deduction as single individuals, with the result that a larger amount of their income was subject to taxation than the income of married couples. In addition, heads of household had higher tax rates than married couples filing jointly. Their rates were mid-way between the higher rates for single individuals and the lower rates for married couples filing jointly.

The TRA marked a big step forward for heads of household. It replaced their standard deduction pegged to the deduction for single taxpayers with a new standard deduction that is closer to the deduction for married couples filing jointly. For example, the standard deduction for heads of household in 1993 is approximately 88 percent of the deduction for married couples, as compared to 60 percent for single filers. The standard deduction for heads of household should, however, be the same as the deduction for married couples filing jointly in recognition of their similar living situations.

In addition, the tax brackets for heads of household should be modified to bring them into line with the brackets for heads of household, so that some heads of household do not continue to have higher tax rates at lower income levels than married couples filing jointly. For example, heads of household currently must begin to pay at the 28 percent rate on taxable incomes above $28,750, whereas married couples filing jointly do not become subject to the 28 percent rate until their taxable income rises above $35,800. Although the head-of-household increases go into effect at a point slightly above the midpoint between the single and married-filing-jointly income levels, the brackets are not equivalent, resulting in a higher burden on single heads of household than married couples with the same income. As the Committee crafts the 36 percent rate, the inequity in the current brackets should be corrected.

- **Making the Dependent Care Tax Credit Refundable and Indexing it for Inflation**

The Dependent Care Tax Credit provides assistance to families who have work-related child or dependent care expenses. The amount of the credit is a percentage of actual expenses incurred for care of a child under age 13 or a disabled spouse or other dependent, up to $2,400 for one individual or $4,800 for two or more. The percentage ranges between 30 percent and 20 percent, with taxpayers with incomes up to $10,000 receiving the highest percentage of expenses as their credit, and taxpayers with incomes over $28,000 receiving the lowest percentage. Accordingly, the maximum credit amounts range from $720 to $480 for taxpayers with one dependent and $1,440 to $960 for taxpayers with two or more dependents. The credit is not refundable and amount of any employer-provided dependent care must be deducted from expenses claimed for the credit.

Since the Tax Reform Act of 1986, the value of the Dependent Care Tax Credit has declined substantially for low-income families. The TRA provided for the indexing for inflation

of all basic provisions of the Internal Revenue Code that determine tax liability except the credit; as a result, fewer and fewer families with incomes low enough to take advantage of the maximum credit amount have any tax liability.[3] Because of this, and because the credit is not refundable, in each year since 1986 more of the credit's benefits have gone to middle- and higher-income families. This result is in direct contrast to Congress' intent since 1982 when it targeted the credit's benefits to low- and moderate-income families.

Thus, in 1986, 21 percent of the returns claiming the credit were from households with adjusted gross incomes (AGIs) under $15,000, 32 percent reported AGIs under $20,000 and 56 percent reported AGIs under $30,000. In contrast, preliminary 1991 data reveal that fewer than 8 percent of the returns claiming the credit were from households with AGIs under $15,000, 17 percent reported AGIs under $20,000, and 37 percent reported AGIs under $30,000. The result is that 63 percent of the returns currently claiming the credit are from households with AGIs above $30,000, as contrasted with 44 percent in 1986. Unless changes are made in the credit, its value to low-income households will continue to erode.[4]

Representative Olympia Snowe introduced a bill in the 102d Congress, which will be reintroduced this year, that would improve the credit to provide increased assistance to low- and middle-income families. While we strongly support the Snowe bill, we believe that at a minimum the credit should be indexed for inflation and made refundable. Adding such a provision to the President's proposal would also further target its distributional effects to the lowest-income families. More importantly, without such changes, the targeting to low- and moderate-income families that Congress added to the credit in 1982 will soon disappear completely.

- **Simplifying and Conforming the Eligibility Criteria for Claiming the EIC, the Dependent Exemption, the Dependent Care Tax Credit and Head of Household Filing Status**

When Congress expanded the Earned Income Credit in 1990, it simplified the test for claiming the credit as well. This simplification has made it considerably easier for families to understand the EIC's eligibility requirements and for IRS to design Form EIC for claiming the credit.[5] Effective for tax year 1991, the previous requirement that an EIC claimant meet the appropriate filing status test, a support test and a residency test was replaced with a simple residency test[6] -- that the child reside with the taxpayer for over six months of the year or, in the case of a foster child, for the entire year.

Prompted in part by this simplification of the EIC, the General Accounting Office has been studying ways to correct erroneous dependent and filing status claims by further simplification and conformity of the Dependent Exemption, the Dependent Care Tax Credit and Head of Household Filing Status. We understand the results of their study will soon be

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[3] In 1993, for example, the tax thresholds for all married couples with children and heads of household are above $10,000; the threshold for heads of household with two or more children are above $12,000 and for married couples with two or more children are above $15,000.

[4] The credit serves two important purposes. First, it recognizes that because employment-related dependent care expenses are so high, families need help in meeting them. Indeed, after food, housing and taxes, dependent care is a working family's greatest expense. Second, the credit recognizes the need to assure fair treatment in federal income tax policies between families who have employment-related dependent care expenses and families who do not have such expenses. Families with such expenses do not have the same ability to pay taxes as families at the same income level without such expenses. This is particularly true for the lower-income families for whom the credit's value is eroding.

[5] Other changes in 1990 made the EIC more complicated -- the addition of the health insurance component of the credit and the young child supplement. We support the President's proposal to eliminate these components in favor of a higher basic credit amount, a proposal also approved twice by this Committee in 1992.

[6] Only if the EIC is claimed for a married child must a support test still be met.

incorporated in bipartisan legislation co-sponsored by Senator Moynihan and Senator Packwood. We urge the Committee to join with the Senate in this effort, which will make it easier for taxpayers to determine their eligibility for these tax provisions by replacing the support test to the extent possible with the residency test that is currently used for the EIC.

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In conclusion, we thank the Committee for the opportunity to testify today and urge adoption of the revenue measures in the President's proposal as well as the tax changes to increase tax equity for women and families that we have proposed today.

STATEMENT OF WOMEN'S ORGANIZATIONS IN SUPPORT OF THE PRESIDENT'S ECONOMIC PLAN

President Clinton has proposed a bold economic plan with the potential to significantly help women and their families by addressing the human needs deficit, the investment deficit and the budget deficit. The goal of the plan is to stimulate the creation of more and better jobs, increase income and support for America's families, and provide long-term structural changes in the economy that will ensure improvements in the standard of living and quality of life for all Americans.

Women and their families have suffered disproportionately from the failure to address the nation's three deficits. The human needs deficit has contributed significantly to the widespread poverty of women and children. The investment deficit has restricted education, training, and job opportunities, hampering the ability of women to support themselves and their families. The budget deficit has swallowed up private savings, leaving few resources to devote to human needs and human capital investments that will promote economic growth and help women and their families thrive and prosper.

We agree that the three deficits must be addressed, and must be addressed simultaneously, to assure the nation's well-being and competitiveness in a global economy. We believe the balance the Clinton plan strikes between investments and deficit reduction, and between spending cuts and tax increases, is generally the right one. Equally important, the spending cuts and tax increases in the plan are for the most part progressive, insulating low-income women and families from their adverse effects and placing the most burden on those best able to bear it.

The plan is not a perfect one, and there are certainly aspects of it with which we disagree. Indeed, we will be working to assure, as the details of the plan are fleshed out, that improvements are made and the plan's promise for women and their families is fully realized. We are particularly concerned about the spending cuts that have been added to the plan by the House and Senate Budget Committees, and will be working to assure they do not adversely affect women. Moreover, as the plan itself recognizes, its goals cannot be achieved without comprehensive health care reform.

But overall, we believe the plan outlined by President Clinton makes changes in human needs programs that are likely to improve the lives of women and their families, and changes in taxes that are fairly distributed and will make our tax system more progressive, to the benefit of women and their families.

Therefore, we urge prompt passage of a Budget Resolution containing the key components of the President's economic plan --

- a short-term stimulus package to promote job creation and begin the long-overdue investment in human needs and human capital critical to a healthy economy;

- a long-term investment package necessary for sustained economic growth and a better life for all Americans; and

- balanced spending cuts and progressive tax increases necessary to achieve the short- and long-term investments and the deficit reduction that are essential to the success of the plan.

As women's organizations, we stand ready to work with the President and the Congress to achieve our shared goal for a society in which women are full economic participants, and the financial security of women and their families is assured.

American Association of University Women
B'nai B'rith Women
Catholics for a Free Choice
Center for Policy Alternatives
Center for Women Policy Studies
Church Women United
Clearinghouse On Women's Issues
Coalition of Labor Union Women
National Council of Jewish Women
NETWORK - A National Catholic Social Justice Lobby
National Organization for Women Legal Defense and Education Fund
National Women's Conference Committee
National Women's Law Center
Planned Parenthood Federation of America
Religious Coalition for Abortion Rights
Society for the Advancement of Women's Health Research
United Methodist Church Women's Division
Voters For Choice
Women's Action for New Directions
Women for Meaningful Summits
Women's Legal Defense Fund
Women's National Democratic Club
Women's Rights Department, American Federation of State, County and Municipal Employees
YWCA of the USA

NATIONAL WOMEN'S LAW CENTER

25 YEARS ADVANCING WOMEN'S RIGHTS

THE PRESIDENT'S ECONOMIC PLAN WILL BENEFIT WOMEN AND FAMILIES

The economic well-being of women and their families -- including future generations of Americans -- is essential to the economic well-being of our nation. The President's plan has real potential to achieve an economic recovery and long-term economic growth in which women will share and their families will benefit, for the reasons set forth below.

I. The plan's investment in human capital and human needs can significantly help women and their families over both the short-and long term.

Examples of investments that will directly help significant numbers of women and families:

- Full funding of the **Head Start** program will help low-income children do better in school and become more productive adults, enable more of their mothers to work in the paid labor force, and create thousands of new jobs, most of which will be filled by women.

- Full funding of the **Special Supplemental Food Program for Women, Infants and Children (WIC)** will improve the health and nutritional need of hundreds of thousands of low-income pregnant and post-partum women and their children.

- Expansion of the **Earned Income Tax Credit** to families with children and earnings up to $30,000, as well as single individuals and couples without children, will provide hundreds of thousands of women -- particularly single heads of households whose median income is well below $30,000 -- the income support necessary to bring themselves and their families out of poverty.

- Increased funding for **health and health-related initiatives** -- research on women's health, childhood immunizations, HIV/AIDS research and prevention efforts, teen pregnancy programs, substance abuse prevention and treatment programs -- will enable more women and their families to live healthy and productive lives.

- Increased funding for the **Child Care and Development Block Grant** will provide sorely-needed child care services to thousands of low- and moderate-income women and their families.

- Funding for **additional staff at the Equal Employment Opportunity Commission** to enforce the Americans with Disabilities Act and the Civil Rights Act of 1991 will provide increased protection against job discriminauon for many women.

- The extension of **Emergency Unemployment Compensation benefits**, already signed into law by the President, will support workers still dislocated by the recession, many of whom are women whose lack of seniority has made them "first fired, last rehired."

Examples of investments that will potentially help significant numbers of women and families and that with appropriate targeting can help even greater numbers:

- Full funding of the **Intermodal Surface Transportation Efficiency Act (ISTEA)** can improve our nation's highway system and provide hundreds of thousands of jobs, which the states are authorized to fund through contracts targeted to women- and minority-owned businesses.

- Increased funding for **elementary, secondary and postsecondary education** reform can provide expanded educational opportunities for girls and young women, and create jobs in schools that many women will fill -- for example, 14,000 jobs for teachers and other personnel in Chapter I schools for the summer of 1993 alone.

- A **National Service** program to employ young people in community service jobs in exchange for educational loans can help women pay for college and other postsecondary schooling as well as provide needed community services to women and their families.

- Increased funding for **mass transit** capital improvements can improve public transportation systems on which women so often depend, as well as create thousands of new jobs.

- An expanded **Jobs Corps, Summer Youth Employment and Training Program, and youth apprenticeship program** can help provide greater incentives and opportunities for young women who are not college-bound to complete high school and receive skills-related training and employment.

- New and increased funding for the **Community Development Block Grant, monies to subsidize, renovate and fight crime in public housing, and a permanent extension of the low-income housing tax credit** can help the predominantly-female public housing population and create thousands of jobs.

- An **investment tax credit** targeted to small businesses can help create new jobs in women-owned businesses -- the fastest-growing segment of the small business community -- and further promote women's entrepreneurship.

II. The plan's spending cuts and tax increases are for the most part progressive, insulating low-income women and families from their adverse effects and placing the most burden on those best able to bear it.

- The **cuts in entitlement programs** will for the most part affect providers of services rather than program beneficiaries, especially low- and moderate-income beneficiaries.

- The most significant cut in entitlement programs, accomplished by an **increase in the taxation of Social Security benefits**, will affect only 23 percent of beneficiaries, whose higher incomes make them both better able to bear the increase in taxes and less likely to be women whose primary means of support is Social Security benefits.

- The **cuts in discretionary spending programs** are in most cases accomplished in programs that have not provided significant assistance to women and their families.

- The most significant tax increase, the **broad-based energy tax**, is offset for individuals and families with incomes below $30,000 -- a group that includes most single-parent families headed by women -- by the expansion of the Earned Income Tax Credit, an increase in Food Stamps, and an increase in the Low Income Energy Assistance Program.

- The **other individual tax increases**, which are imposed on individuals with taxable incomes above $115,000 and couples with taxable incomes above $140,000, do not affect most women and their families and have the beneficial effect of making the tax code more progressive.

Mr. LEWIS. Thank you, Ms. Campbell.

Ms. Erlandson, as you know, one of the objectives of the administration energy tax is to change behavior relative to energy consumption. Wouldn't it be more consistent with that objective to move the collection point closer to the consumer and not further upstream as you suggested?

Ms. ERLANDSON. The environmental community generally has been advocating that the point of collection remain upstream, and the reason is that there is energy used throughout industrial processes, beginning with the extraction of, say, oil and gas from a well, and those processes can be more or less efficient. To the extent that the tax is retained as much as it can be at that point, there is an incentive to make those processes more efficient. The same would apply for utilities and other consumers of energy who are not households.

Mr. LEWIS. Thank you very much.

Ms. Campbell, in your testimony, you suggested that the tax brackets for heads of households should be brought into line with the tax bracket for joint filers. Wouldn't this add to the so-called marriage penalty? What happened to people who happen to be married?

Ms. CAMPBELL. Of course, that is the reason why before 1986, essentially, heads of household had the same bracket as singles, and when we advocated that it should be moved to be the same as married couples in 1986, the response was, "Well, we will move it about 80 percent of the way because we don't want to create a marriage penalty and dissuade heads of households from getting married and benefiting from the lower marriage tax rates."

I think that that is an issue that should be looked at perhaps more closely, but, in our view, there haven't been any studies that have demonstrated that, in fact, it does operate that way. Rather, we think all it does is penalize heads of households who have to pay taxes in some instances at a higher rate than married couples, and that is our concern.

Mr. LEWIS. Did I understand you or did I hear you right? Did you suggest that women under our tax structure, our present tax system, tend to pay more than men?

Ms. CAMPBELL. No. No; I didn't.

Mr. LEWIS. You didn't say that?

Ms. CAMPBELL. No; I didn't. I said that they would have enough income to pay more than men—because their incomes are generally lower than men, they benefit from a more progressive tax system. If the system isn't progressive, then they may pay disproportionately more than people with higher incomes, which tend to be men. But I was really making the point that the more progressive the system is, the better it is, I think, for all Americans, but particularly for women because of their lower incomes.

Mr. LEWIS. Thank you very much.

Mr. Santorum.

Mr. SANTORUM. Thank you, Mr. Chairman. I have a few questions for Ms. Erlandson.

I want to pick up on what the chairman was just talking about with the point of taxation. You would suggest that we make it as

early in the process, as upstream as possible. With respect to oil, where would that point be in your opinion?

Ms. ERLANDSON. Preferably at the wellhead. Now, we understand there are concerns about imports of gasoline, for example, where the energy used in the refinery process overseas would avoid taxation relative to domestically refined gasoline.

Our solution to that is instead of moving the point of taxation to the end of the refinery process would be to assess the appropriate tax on the import that would take into account the embedded energy from refining overseas.

Mr. SANTORUM. So you would ask for even additional taxes on oil, on gasoline being imported. So, in addition, to the Btu tax, you want a tax on oil imports, on gasoline imports?

Ms. ERLANDSON. No. No; I think you misunderstood what I said. The tax——

Mr. SANTORUM. No, I think I understood exactly what you said. You want a fee tax—call it a fee, call it a tax, whatever you want to call it—on gasoline imported to make up the difference for the tax, the Btu tax, that the refiners are paying.

Ms. ERLANDSON. Both imports and domestically refined gasoline, for example, would have to pay the Btu tax.

Mr. SANTORUM. I understand that, but that is not the point I am making.

Ms. ERLANDSON. The energy used in the refinery process, if you move the point of collection down to after the——

Mr. SANTORUM. Let's talk from your assumption. If you have the tax, the incidence of tax at the well or at the dock, then——

Ms. ERLANDSON. Then you don't need to put an additional tax on the imported product.

Mr. SANTORUM. You don't?

Ms. ERLANDSON. No.

Mr. SANTORUM. But what you have done is create a tremendous savings for people who refine their oil overseas and then ship the gasoline here refined without that tax being paid on the refining process. So you put us at a competitive disadvantage.

Ms. ERLANDSON. Let me simplify this. Refined products, whether imported or produced domestically, should be taxed the same.

Mr. SANTORUM. So you would suggest a gas tax on imported gasoline, some sort of fee to make up the difference for the tax paid at the refinery, right? So you are asking for even more taxes to make up for the difference in taxes.

Ms. ERLANDSON. Well, it would result in an equal gasoline tax.

Mr. SANTORUM. But it is even additional taxes is the point, I think, I am trying to make here.

I mean, how high a tax would you go? You said you compromised on this plan. Should we pay even higher? Is this too low of a Btu tax? Should we have a higher Btu tax? How high was your suggestion to the administration?

Ms. ERLANDSON. We did not make a specific suggestion.

Mr. SANTORUM. How high would you make it to us?

Ms. ERLANDSON. We don't necessarily have one. It depends on the overall goals of the committee and the administration.

One of the goals of the President is to induce energy efficiency and to promote reliance on clean energy sources, like renewables.

Mr. SANTORUM. But would an 8-percent Btu tax be a better tax?

Ms. ERLANDSON. I don't want to get into this discussion over a rate because we haven't done numbers on each individual rate to see what all of the impacts would be.

Mr. SANTORUM. So you don't know whether a 6-percent rate would even be actually better than a 7-percent rate or a 10-percent rate would be better?

Ms. ERLANDSON. Generally speaking, the higher the rate, the more efficiency you will see and the more fuel switching you will get to cleaner sources of energy, like natural gas.

Mr. SANTORUM. So, in other words, you would suggest even a higher rate to accomplish your purposes?

Ms. ERLANDSON. Correct, and then you could use those tax increases to offset other taxes or to reduce the deficit or whatever purpose.

Mr. SANTORUM. I want to turn now to manufacturing. That is a very important issue in my district. It was a very heavy manufacturing area. It still is to some extent. The concern that a lot of people in my district have is that they closed down a lot of our mills, and a lot of the steel that is being made now is not being made in Pittsburgh. It is being made in other areas of the country, other areas of the world, where the environmental laws are not nearly as stringent as the ones that are imposed on industries here.

It seems to me what we are doing with this tax is doing the same kind of things through an environmental tax as opposed to environmental regulation. We are moving manufacturing operations by virtue of making them uncompetitive with this tax, moving them to other countries where their environmental laws are not nearly as stringent as ours. Therefore, if we really are friends of the Earth and not just friends of my backyard and concerned about the pollution in my backgrounds, would we not be working to keep manufacturing operations alive and productive here in this country instead of shipping them to some third-world country where the pollution is just abysmal?

Ms. ERLANDSON. Yes.

Mr. SANTORUM. And you have nothing in this proposal that does that. In fact, you have everything in this proposal that sends more manufacturing to those very same countries.

Ms. ERLANDSON. What we have been advocating for some time in the tax area is a revenue-neutral tax shift to discourage pollution and cut taxes on income.

Mr. SANTORUM. I understand that, but this tax does not do that, does it?

Ms. ERLANDSON. Well, it was not the tax that we proposed. It is the tax that the President proposed, and he listened to lots of people beyond the environmental community.

Mr. SANTORUM. If I can just finish, then the net effect, at least according to what the people from my district are telling me, will be, in fact, more pollution globally if we shut down more manufacturing jobs in the United States as a result of this Btu tax?

Ms. ERLANDSON. I would be happy to work with you, sir, to try to prevent that from happening.

Mr. SANTORUM. Thank you, Mr. Chairman.

Mr. LEWIS. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman, and I thank our witnesses for their testimony.

First, Ms. Erlandson, a question I have that concerns me about this energy tax is how that is passed through to all consumers. It is really an unavoidable hit, and it is so complicated that it is not really that easy to ascertain even with expanded food stamps; for example, with the earned income tax credit. That cutoff is not going to be changed if it is a couple with one child. I mean, everybody gets cut off at $23,760, even under the administration's proposal.

Factoring in how many Btu's are in the production of food, that is an extremely complicated question. I was talking to farmers back home who told me that just the Btu component of fertilizer per acre is going to add $35 an acre to the production of corn and soy beans. That is before you figure out how many Btu's go in the production of a tractor, a plow, a disk. You are going to have increased labor costs, of course, because it is going to cost more to live for everyone. So that is an increased cost in the production of food.

Then you have the transportation costs that are aggravated not just for the production of the trucks, but for the gasoline tax. Then you have the processing, the packaging, the distribution. As I say, it is an awfully complicated question. When we have had sales taxes back home, traditionally, we exempted food from the application of that sales tax at the checkout counter because of the working poor.

Are you not in favor of at least trying to provide some kind of mitigation on basics like that in, say, health care? I have seen one, the Heritage Foundation, that did just a preliminary assessment of the increased cost of health care with that Btu tax, and that is somewhere between $4 and $5 billion a year to health care providers. You have to heat the hospital, the electricity, how many Btu's go into a CAT scanner, an operating table, an x ray, the plastic gloves, the jackets they wear, and everything that has that Btu hit.

Would you be sympathetic to the idea of trying to exempt health care from the Btu hit and simultaneously consider exempting food altogether from the Btu hit?

Ms. ERLANDSON. First, let me just pull out one of the points that you made. You mentioned fertilizers and plastics. My understanding is, for example, that petrochemicals used as feedstocks to make plastics or fertilizers are not taxed. Only energy is.

In the case of exemptions for particular industries, I agree with you that lower-income people cannot afford to pay higher taxes. They can't afford to pay their bills the way it is, and that appropriate mechanisms need to be designed to help them adapt.

Perhaps the Food Stamp Program, which does not reach all people that need the help, needs to be revamped to make sure that those who need the help get it, and maybe there is something other than the Food Stamp Program that could be used to do that.

I think that to exempt whole industries from the tax begins an unraveling process and ultimately dooms the energy tax as a whole, and then the committee is faced with the proposition of either raising other taxes or increasing the deficit, and that is a decision for you to make.

I would just like to leave you with the willingness on the part of the environmental community to work with people who have specific concerns about the energy tax and its impact, particularly on consumers.

Mr. CRANE. Ms. Campbell, you are a great champion of progressivity in the Tax Code, but will you explain to me, if you work 8 hours a day, a 40-hour week, and I work overtime 60 hours, same pay scale, why should you take a hit at me?

Ms. CAMPBELL. Excuse me?

Mr. CRANE. Why should you take a hit at me?

Ms. CAMPBELL. What do you mean by take a hit at you?

Mr. CRANE. If I am putting in a 60-hour week and I am making more money than you.

Ms. CAMPBELL. And you are making more money?

Mr. CRANE. Right. Of course. I am working 60 hours in a week, the same hourly wage scale as you. You are working 40 hours a week. What gives you the legitimate right to take a hit at me when I am putting in 50 percent more time?

Ms. CAMPBELL. I think, so far, the tax system operates on income and not on another system of valuating work. I mean, there have been discussions about women who are working at home, taking care of children, and not getting any salary, and whether there should be imputed income and imputed taxation and other kinds of ways of measuring value by hours or otherwise. It is a question of how complicated you want it to get.

My view is that it is appropriate to judge it on income, and then if you are making more, you have a greater ability to pay tax. We may have a disagreement, but that is my view.

Mr. CRANE. We do have a profound disagreement because I think proportional taxes are fair, and people who make more under proportional taxes pay more. But we are all buying the same services from Government, and I think progressivity is a social theory that is bad practice.

With that, I yield back the balance of my time.

Mr. LEWIS. Thank you, Mr. Crane.

Let me just thank you two, Ms. Erlandson and Ms. Campbell, for all of your good work, and I look forward to working with you in the years to come and wish you well. Thank you for your testimony and for being here today.

Ms. ERLANDSON. Thank you, Mr. Chairman.

Ms. CAMPBELL. Thank you, Mr. Chairman.

Mr. LEWIS. Would the next panel come forward, which is Ms. Rowell-Williams, Mr. Hubbard, Mr. Nerney, Mr. Trauscht, and Ms. Hall.

We are delighted and very pleased to have you. As I have said to other witnesses, you may submit your complete statement for the record, and you can summarize. We would encourage you to be brief.

Thank you very much.

Ms. Rowell-Williams.

STATEMENT OF MOLLENE ROWELL-WILLIAMS, SENIOR PUBLIC PROGRAM COORDINATOR, TACO BELL CORP., IRVINE, CA

Ms. ROWELL-WILLIAMS. Good afternoon. I am Mollene Rowell-Williams, senior public program coordinator for Taco Bell. My position includes the coordination of the TJTC program nationwide.

Through an aggressive incentive bonus program, our managers in the past 5 years have increased sevenfold the number of TJTC-certificate employees hired annually. Our field management staff in the past 2 years has included over 1,300 employees, originally hired from one of the TJTC-targeted groups as shift managers, assistant managers, or restaurant managers all over the United States.

The TJTC program has had a significant impact at Taco Bell in increasing the proportion of disadvantaged workers that we hire. In 1992, 1 out of every 5 new jobs went to TJTC-eligible workers. This was the first work experience for almost one-half of this group. One-quarter had been on a Government assistance program, such as welfare or AFDC, immediately preceding their joining Taco Bell.

Many managers understandably had an inherent resistance to hiring structurally unemployed workers because of the need for closer supervision and training due to their lack of prior stable work history.

The tax credit available through the TJTC program helps to reduce this additional cost of time and effort required of a manager while Taco Bell's bonus incentive program for hiring TJTC eligibles motivates the manager to make the effort to seek out, hire, and train these disadvantaged workers.

A formal training program is provided to all new employees, leading to a potential career path from a crew member to shift manager, assistant manager, and restaurant manager. New employees are trained in teamwork skills, customer relations, and operations. Additional training follows in financial controls, problem-solving, and communications, all aimed at developing operational and managerial skills. This investment in training is offered to all employees, and many TJTC employees have begun successful careers as a result of this experience.

In 1991, Taco Bell was planning a further expansion of the TJTC program. We were considering the development of a formal outreach program throughout the United States to supplement the individual efforts of the local managers. This program would strengthen our restaurant's relationship with local job service offices and community-based organizations to enable us to seek out and identify TJTC-eligible job applicants.

We had begun a version of this program in Florida, Mississippi, and Pennsylvania and believe it would be applicable for the 40,000 new jobs that would be generated in the next 2 years at the many new locations we will be opening.

This planning had to be delayed when TJTC was extended for just 6 months, through June of 1992. Although we have continued to hire TJTC-eligibles during the current hiatus, because of assurances that it would be effective retroactive to last July, we could not commit to the outreach program until we were certain there would be long-term program continuity.

We have public program managers located across the United States, and the budgeting and planning required for their implementation of an outreach program at our 2,400-plus, company-owned restaurants must necessarily be done in the context of, at least, a 3 to 5 year horizon.

While TJTC is an important part of our hiring process, it will become an ongoing integral part of Taco Bell's and other companies' culture only if there is a long-term program continuity, rather than stop-and-go, short-term extensions. This will increase employment opportunities for many thousands of physically and economically disadvantaged workers as businesses enthusiastically embrace the program with the knowledge it could be incorporated in their long-range planning.

Thank you.

[The prepared statement follows:]

STATEMENT OF MOLLENE ROWELL-WILLIAMS, SENIOR PUBLIC PROGRAM COORDINATOR FOR TACO BELL

INTRODUCTION

Good morning. I am Mollene Rowell-Williams, Senior Public Programs Coordinator for Taco Bell. My responsibilities include the coordination of the TJTC program nation-wide for Taco Bell.

Taco Bell is part of the Pepsico restaurant system, which encompasses Taco Bell, Pizza Hut and Kentucky Fried Chicken with over 8,000 company-owned outlets in the United States. Pepsico employs close to 300,000 employees in the United States including over 60,000 at Taco Bell's 2,400 company-owned restaurants. One out of every five of the Taco Bell employees hired annually are TJTC-eligible and 5% of the field management group--shift managers, assistant managers, restaurant managers, etc., -- began their careers through the TJTC program progressing, to this level within 2-3 years of employment.

In the next two years, through an aggressive $1.5 billion expansion program, Taco Bell will be opening new locations, especially in the Northeast, Southeast and Mid-West, that will generate 40,000 new jobs, including 7,000 to 10,000 that will come from TJTC-eligible workers. Taco Bell has used TJTC as an important component of its hiring system for many years and this program will be a major part of the effort to provide staffing for the expansion units. If the same pattern holds true for these expansion units as it does for existing locations, Taco Bell's training and development of these new employees will result in many of them moving into the managerial ranks within 1-3 years of their employment.

Taco Bell facilitates the opportunity for all new employees' advancement by providing a career path and related training. This path begins with the entry level job of crew member, then after training and experience proceeds to assistant general manager, restaurant manager and multi-unit manager. Upper level field management positions follow, e.g., market manager and zone manager. Every new employee is first taught the skills necessary for team work, customer relations and operations through a formal company training plan. Additional training in financial controls, problem solving and communications further develop the employee's managerial abilities. Well over 1,300 TJTC-eligibles have progressed through this career path to management jobs in the past two years.

The TJTC program has proven to be a strong financial incentive for Taco Bell managers to seek out, hire, train and retain TJTC eligibles. Given the program continuity of a permanent extension, Taco Bell will further expand its efforts to reach out to the local community to identify and hire an even greater proportion of TJTC-eligible workers. TJTC is an effective, user-friendly system that provides job opportunities for the most difficult to employ workers, and incentives to business to hire these workers, a combination that really works, in the most practical sense, to the benefit of all involved.

TJTC HISTORY AT TACO BELL

Taco Bell has been involved with the TJTC program since the mid-1980's and began a serious, organized effort to integrate the program as part of its hiring process in 1988. From 1988 through 1992, the number of TJTC-certified employees hired by Taco Bell annually increased seven-fold. In 1992 alone, over 24,000 TJTC-eligible employees were hired by Taco Bell and nearly 1,300 of the field management team in 1991 and 1992 was staffed by employees originally hired through TJTC.

This was accomplished through the establishment of public program managers who are located across the United States. Their responsibilities include involvement with all government programs. One of their major responsibilities is encouraging the participation of all location managers in the TJTC program. Furthermore, the restaurant managers themselves have incentives to hire TJTC workers. The TJTC credits realized through the program are incorporated as an offset to the labor costs on their P&L. Not only can managers realize substantial bonuses by exceeding their P&L goals, but they are actually penalized, and even disqualified from all bonus consideration if the labor cost goal (including the TJTC offset) itself is not met. This not only encourages the hiring of TJTC workers, but the retention of these employees to increase the credits at each location. Through this P&L incentive program, Taco Bell has woven into the day-to-day management fabric the TJTC process, rather than making it a separate issue that may or may not get the manager's attention. Finally, the TJTC-eligible employee is rewarded with a $25 bonus for completing the vouchering process through the Job Service system.

This comprehensive internal program has directly contributed to a shift in hiring practices from as recently as five years ago. Managers now actively seek out TJTC-eligible workers through contacts with Job Service offices. They have seen that the average tenure of such employees is at least as good as non-TJTC workers, and their productivity equally high. There is an initial additional effort required to acclimate many TJTC employees to the world of work, since for nearly one-half of these workers their job at Taco Bell is their first one. The TJTC credits, and the incentive bonuses available to the managers for meeting TJTC goals, encourages them to make the additional effort necessary to integrate the TJTC worker into our work force.

In late 1991, Taco Bell was considering the expansion of the next phase of their TJTC program, a coordinated nationwide outreach program to identify TJTC-eligible job applicants from Job Service offices and community-based agencies. This type of effort began in areas such as Jacksonville, Florida, South Haven, Mississippi and Philadelphia, Pennsylvania, and was done in conjunction with the JTPA/OJT programs. The planning for the implementation of the TJTC outreach program had to be put on hold when TJTC was extended for just six months, through June 1992. Subsequently, the current hiatus has further delayed the start of this TJTC expansion. A long-term outreach program, since budgets and planning approvals must be established well in advance and for 1-5 year periods.

Although we had to delay the formal outreach program due to the hiatus, we have continued to use TJTC even after it ended on June 30, 1992. We have done this based on Congressional assurances that when TJTC is renewed, it would be effective for all hires as of July 1, 1992.

SUMMARY

The TJTC program has been a great motivator in promoting job opportunities for physically and economically disadvantaged workers. More than 24,000 such workers are hired annually by Taco Bell. This is often the first work experience for these employees. Over 25 percent of them had been receiving some form of government assistance, such as Aid For Dependent Children or welfare, just prior to securing a position at Taco Bell. More than 1,300 of them are now in field management. Those that leave Taco Bell do so almost entirely of their own accord, for new opportunities. Without the financial incentives offered to companies through the TJTC program this would never have happened. Taco Bell, like all companies, is bottom-line oriented, and the fact that the TJTC program makes good business sense is the key factor in how well it has succeeded. Now if program continuity can be assured, it will become even more of an integral part of the business community's hiring process.

Mr. LEWIS. Thank you very much.
Mr. Hubbard.

STATEMENT OF JAMES B. HUBBARD, DIRECTOR, NATIONAL ECONOMIC COMMISSION, THE AMERICAN LEGION

Mr. HUBBARD. Thank you, Mr. Chairman.

The American Legion is pleased to present to this committee the views of our 3.1 million members on the legislation on TJTC. As this committee is aware, the checkered history of TJTC over the past several years has caused the program to be much less effective than would be the case if it were permanent. Each hiatus between extensions causes more confusion, and more employers drop out, causing fewer veterans and others to be hired.

A few facts from the Department of Labor about veterans, Mr. Chairman. Black and Hispanic veterans experience higher rates of unemployment than their white counterparts. A black male veteran is more than twice as likely to suffer the rigors of unemployment than a white male veteran. Of all the veterans with a disability rating of 60 percent or higher, more than two-thirds are out of the labor force. While the unemployment rate for veterans is somewhat below that for the population in general, the unemployment rate for male veterans between 35 to 39 years is up to 11.9 percent in January of 1993.

TJTC works, and it works for veterans. Between 25 and 30,000 veterans per year have obtained meaningful employment through TJTC.

Mr. Chairman, there is also strong evidence that the subsidy involved in the operation of TJTC is seriously overstated. It is very likely that welfare payments, unemployment compensation, and other general assistance payments made to unemployed workers are significantly reduced when TJTC induces employers to recruit and hire eligible people.

This committee should also be aware that, as the U.S. military begins to grow smaller, there will be more veterans on the street seeking work. In the next 5 years, the size of the Armed Forces will be reduced by approximately another 500,000 people. Over one-half of these people released are married. They will need immediate assistance in finding employment in order to meet the responsibilities of caring for a family.

More than 30 percent of those released are minorities. Some of them will return to inner cities, where unemployment is endemic. About 11 percent released will be women. In some cases, spouses of former service men and women will also need assistance in finding meaningful employment. TJTC is one of the tools available to the employment services across the Nation to help these people.

The American Legion has concluded, Mr. Chairman, that TJTC is one of the most efficient and cost effective of all Federal assistance programs. With TJTC, nobody loses. Economically disadvantaged workers gain an opportunity to demonstrate their ability to become productive members of society and to move toward financial independence. Employers are able to hire a capable work force and receive a tax credit. The Nation's public assistance rolls are reduced as workers move from welfare and unemployment rolls to the tax rolls.

Mr. Chairman, the American Legion respectfully urges a permanent extension and retroactivity of the TJTC Program.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF JAMES B. HUBBARD
DIRECTOR, NATIONAL ECONOMIC COMMISSION
THE AMERICAN LEGION
TO
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

March 31, 1993

The American Legion is pleased to present to this committee the views of our 3.1 million members on H.R. 325 the Targeted Jobs Tax Credit proposal before the Congress. Mr. Chairman, in the best of all possible worlds, we would like to see this program made permanent. As this committee is aware, the checkered history of TJTC over the past several years has caused the program to be much less effective than would be the case if it were permanent. Each hiatus between extensions causes more confusion and more employers drop out causing fewer veterans to be hired.

We are extremely pleased that H.R. 325 expands the eligibility from serving only Vietnam era veterans to veterans who are economically disadvantaged. Mr. Chairman, it is right and proper that this nation should offer an employment subsidy targeted at workers or potential workers who have borne the burden of unemployment at a rate higher than the rest of society. In our view, the historical imbalance seen in the distribution of unemployment can only be remedied by the creation and continuance of incentives for employers to make extra efforts to hire those targeted workers, which include the disabled, minorities, veterans and others. TJTC has served these groups well by creating an "employment advantage" for these groups.

Veterans have been one of the beneficiary groups served by TJTC for some very good reasons. Apart from the fact that these men and women donated a portion of their lives, and in some cases risked their lives for our country, some of them are now chronically unemployed. They need the assistance of this nation and TJTC can help. The data tabulated by the Department of Labor and published as WORKFORCE 2000 AND AMERICA'S VETERANS is still valid. Consider the following from that report:

> **Black and Hispanic veterans experience higher rates of unemployment than their white counterparts.**
>
> **A black male veteran is more than twice as likely to suffer the rigors of unemployment than a white male veteran.**
>
> **Of all the veterans with a disability rating of 60% or higher, more than two-thirds are out of the labor force.**

While the unemployment rate for veterans is somewhat below that for the population in general, the unemployment rate for male veterans between 35-39 years is up to 11.9% for January 1993.

Mr. Chairman, TJTC works. The Wharton School of Business at the University of Pennsylvania has concluded that the program has been effective in fulfilling the objectives for which it was intended. TJTC also works for veterans. Between twenty-five and thirty thousand veterans per year have obtained meaningful employment through the TJTC program.

Mr. Chairman, there is also strong evidence that the subsidy involved in the operation of TJTC is seriously overstated. It is very likely that welfare payments, unemployment compensation, and other general assistance payments made to unemployed workers are significantly reduced when TJTC induces employers to recruit and hire eligible people. We believe that the Departments of Labor and Health and Human Services should jointly do a study of the dollar amount of transfer payments saved by those employed through the TJTC program.

This committee should also be aware that as the United States military begins to grow substantially smaller, there will be more veterans on the street seeking work. In the next five years, the size of the armed forces will be reduced by approximately 500,000 people. Over one half of the people released are married, and will need immediate assistance in finding employment in order to meet the responsibilities of caring for a family. More than 30% are minorities, some of whom will return to the inner cities where unemployment is endemic. About 11% of those released will be women. In some cases, spouses of former service men and women will also need assistance in finding meaningful employment. TJTC is one of the tools available to the employment services across the nation to help these people. We are not concerned with those members of the military who have learned a marketable skill while on active duty. We are concerned with those who have served their country in the infantry, armor or artillery branches of the Army or the Marine Corps or in the Air Force, Navy or Coast Guard where the skills learned are not directly transferrable to the civilian workforce. Many of these people are minorities from inner cities who will qualify for TJTC. As I have mentioned before, many of these same people are married with families. TJTC can be an important tool for them.

The American Legion has concluded, Mr. Chairman, that TJTC is one of the most efficient and cost effective of all federal assistance programs. With TJTC nobody loses. Economically disadvantaged workers gain an opportunity to demonstrate their ability to become productive members of society and to move toward financial independence. Employers are able to hire a capable work force and receive a tax credit. The nation's public assistance rolls are reduced as workers move from the welfare and unemployment rolls to the tax rolls. The American Legion respectfully urges a permanent extension of the TJTC program.

Mr. LEWIS. Thank you very much.
Mr. Nerney.

STATEMENT OF FRANK NERNEY, MANAGER, COMMUNITY EMPLOYMENT AND TRAINING INITIATIVES, MARRIOTT CORP., AND ON BEHALF OF NATIONAL EMPLOYMENT OPPORTUNITIES NETWORK

Mr. NERNEY. Thank you, Mr. Chairman.

I am speaking on behalf of the Marriott Corp. in support of the permanent renewal of the Targeted Jobs Tax Credit Program. I have been working with this program since its inception and have witnessed the many benefits experienced by the structurally unemployed and persons with disabilities. This is a program that has accomplished most of what the Congress set out to do when they first instituted it in 1979.

It has caused us to alter our hiring practices to include outreach to disadvantaged persons, spending extra time and patience in training and working with the Employment Service and various resource agencies in coaching and counseling.

I have a staff of regional managers whose responsibilities include training line managers in TJTC compliance procedures, proper resources for outreach, and the importance of extra up-front time spent in training and counseling. With TJTC workers having little or no work history, employers experience lower productivity as these individuals make the many initial adjustments to the workplace. The costs for this special treatment can be offset by the reimbursement through the Targeted Job Tax Credit.

The TJTC Program provides job opportunities to eligible new hires, helping them break the cycle of unemployment, giving them a work history, and a résumé. Because of the TJTC Program, Marriott has developed preemployment and new hire programs, such as the Pathways to Independence system. This program was developed to assist disadvantaged persons and persons with disabilities to adjust to the work environment with 2 to 6 weeks of workplace and life skills training.

Many of the skills taught in this program are those that many of us take for granted. This includes basic hygiene, fundamental math and budget counseling, interpersonal skills between employee and supervisor and fellow workers. It also includes basic explanations of the reasons for various rules and regulations. They learn that a lack of commitment and dependability is disruptive to coworkers and managers alike.

We believe that having the understanding of cause and effect leads to a more conscientious employee and, therefore, a much more successful work experience. These training programs, while extremely enriching to the employee, cost time and money, a decided luxury in this economy. The justification for the development and execution of this program is the offset of costs through credits from the TJTC Program.

At this time, the belief that there will be retroactive renewal of TJTC has kept many of our outreach efforts going. The long delays in TJTC renewal, however, have not been without their toll. An increasing number of outreach agreements that are regularly renewed cannot be completed. The loss of momentum that is suffered

during this long hiatus is destructive to the success of the program. People begin to lose the commitment, believing that the program no longer exists.

I cannot emphasize enough the need for permanent renewal of this program, so that many other companies will develop the long-term commitment to permanent outreach programs, commitment to training of TJTC-eligible persons, and hiring and training of persons with disabilities. The positive effect of this program becomes beaten and battered by the lack of a timely renewal.

Without a commitment to TJTC renewal, I will be forced to lay off my staff of TJTC coordinators, and the outreach and training programs will be discontinued. There will be a lot of losers if that happens.

At this time, when competition for all jobs is extremely high, those with little or no experience need more help than ever in finding employment. To this end, with the administration placing more and more emphasis on the creation of jobs, TJTC becomes a more necessary and vital tool than it has ever been before.

Let's get this program moving again, and we will know that we have done our part in getting the economy back on the right path.

Thank you very much.

[The prepared statement follows:]

TESTIMONY ON RENEWAL
FOR TARGETED JOBS TAX CREDIT PROGRAM

March 29, 1993
Janet M. Tully,
Director, Community Employment and Training Initiatives,
Speaking on behalf of Janet M. Tully is Frank Nerney, Manager, CETP
Marriott Corporation, Washington D.C.

Mr. Chairman and Members of the Committee,

I am speaking on behalf of the Marriott Corporation in support of the permanent renewal of the Targeted Jobs Tax Credit Program. I have been working with this program since it's inception and have witnessed the many benefits experienced by the structurally unemployed and persons with disabilities. This is a program that has accomplished most of what the Congress set out to do when they first instituted this program in 1979.

It has caused us to alter our hiring practices to include outreach to disadvantaged persons, spending extra time and patience in training, and working with the Employment Service and various resource agencies in coaching and counseling. I have a staff of Regional Managers whose responsibilities include training line managers in TJTC compliance procedures, proper resources for outreach and the importance of extra up-front time spent training and counseling. With TJTC workers having little or no work history, employers experience lower productivity as these individuals make the many initial adjustments to the work place. The costs for this special treatment can be offset by the reimbursement through the Targeted Jobs Tax Credit.

The TJTC program provides job opportunities to eligible new hires, helping them break the cycle of unemployment, giving them a work history, a resume. Because of the TJTC program, Marriott has developed pre-employment and new hire programs such as the Pathways to Independence system. This Program was developed to assist disadvantaged persons and persons with disabilities to adjust to the work environment with two to six weeks of work place and life skills training. Many of the skills taught in this program are those that many of us take for granted. This included basic hygiene, fundamental math and budget counseling, interpersonal skills between employee and supervisor, and fellow workers. It also includes basic explanations of the reasons for various rules and regulations. They learn that a lack of commitment and dependability is disruptive to coworkers and managers alike. We believe that having the understanding of cause and effect leads to a more conscientious employee and therefore a much more successful work experience. These training programs, while extremely enriching to the employee, cost time and money, a decided luxury in this economy. The justification for the development and execution of this program is the offset of costs through credits from the TJTC program. At this time, the belief that there will be retroactive renewal of TJTC has kept may of our outreach efforts going. The long delays in TJTC renewal, however, have not been without their toll. An increasing number of outreach agreements that are regularly renewed cannot be completed. The loss of momentum that is suffered during this long hiatus is destructive to the success of this program. People begin to lose the commitment believing that the program no longer exists. I cannot emphasize enough the need for permanent renewal of this program so that many other companies will develop the long term commitment to permanent outreach programs, commitment to training of TJTC eligible persons and hiring and training of persons with disabilities. The positive effect of this program becomes beaten and battered by the lack of a timely renewal. Without a commitment to TJTC renewal, I will be forced to lay off my staff of TJTC coordinators and the outreach and training programs will discontinue. There will be a lot of losers if that happens. At this time, when competition for ALL JOBS is extremely high, those with little or no job

experience need more help than ever in finding employment. To this end, with the administration placing more and more emphasis on the creation of jobs, TJTC becomes a more necessary and vital tool than it ever has been before. Let's get this program moving again, and we'll know that we've done our part in getting this economy back on the right path.

Mr. LEWIS. Thank you very much.
Mr. Trauscht.

STATEMENT OF DONALD C. TRAUSCHT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BORG-WARNER SECURITY CORP., CHICAGO, IL, ON BEHALF OF JOB OPPORTUNITIES BUSINESS SYMPOSIUM

Mr. TRAUSCHT. Mr. Chairman, I am Donald Trauscht, chairman and chief executive officer of Borg-Warner Security Corp., headquartered in Chicago, IL. I am testifying today not only for my own company, but also on behalf of the Job Opportunities Business Symposium, or JOBS, a coalition of 10 major employers around the country dedicated to the renewal and improvement of Targeted Jobs Tax Credit. A list of those companies is on the cover page of my statement before you.

Mr. Chairman, Borg-Warner and the other employer members of JOBS strongly support the retroactive and permanent extension of the Targeted Jobs Tax Credit as proposed by President Clinton. The program works and works efficiently in the way it was intended; that is, the delivery of jobs by private industry for workers who would otherwise remain unemployed.

While the proposal by the President to expand TJTC to a new category of youth apprenticeship is appealing, our group strongly supports reinstating a category of 23- and 24-year-olds which was eliminated in 1988. Our experience at Borg-Warner is that TJTC is especially helpful to the 23- and 24-year-old category of potential workers.

Perhaps Borg-Warner's experience could help you better understand the success of TJTC in the real job market. Borg-Warner Security Corp. is the Nation's largest provider of security services. Our operations include two major providers of contract security guards, Burns International Security Services and Wells Fargo Guard Services. Our other units are Wells Fargo Alarm Services, Wells Fargo Armored Service Corp., and Pony Express Courier. We employ more than 85,000 people throughout a nationwide network of approximately 575 branch offices.

The very nature of our business means that we actively recruit the most responsible, alert, and conscientious people possible. Why, therefore, should we preferentially hire less-skilled workers who often do not have an employment history?

The answer is that TJTC-eligible employees can be very good employees if given the chance, and that chance has been provided through TJTC. At Borg-Warner, we found that the tax credit available through the program was sufficient incentive to alter our traditional employment practices. This is the key point, Mr. Chairman. The way we hire people now is much different than even 10 years ago.

At Borg-Warner, TJTC is not administered by the tax department, the accounting department, or the personnel department. It is a business activity that is managed by the business unit head, just as they manage sales, inventory, and expense controls. Incentives to seek, hire, pay, and retain TJTC-eligibles are dispersed throughout the organization, concentrated at the field level where

the real work of recruitment and retention is carried out. You can see that we are serious about TJTC.

Mr. Chairman, there are two criticisms of the program which I would like to briefly address. The first is the criticism that TJTC is a minimum wage program for dead-end jobs. Our experience challenges this. Also, the average wage of all TJTC-vouchered employees at Borg-Warner Security is considerably higher than the minimum wage.

Another concern about TJTC is whether it provides longer-term employment. An employee retention study, we commissioned internally, found that TJTC-eligible security guards remained with us nearly three times longer than non-TJTC security guards. The study concluded that we should continue and expand our TJTC Program.

Mr. Chairman, this is a win-win program. The Federal Government wins because TJTC helps the hard-to-employ find jobs. Employers like Borg-Warner Security win because of the tax credit incentive to go the extra mile in recruiting, but, most importantly, the TJTC-eligible employees win when they are given a chance where none existed before.

We urge you to retroactively and permanently extend this vital program.

Thank you.

[The prepared statement follows:]

STATEMENT OF DONALD C. TRAUSCHT, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BORG-WARNER SECURITY CORP., CHICAGO, ILL., ON BEHALF OF THE JOB OPPORTUNITIES BUSINESS SYMPOSIUM (JOBS)

Mr. Chairman and members of the Committee, I am Don Trauscht, Chairman and CEO of Borg-Warner Security Corporation, headquartered in Chicago, Illinois. I am testifying today not only for my own company, but also on behalf of the Job Opportunities Business Symposium, or JOBS, a coalition of ten major employers around the country dedicated to the renewal and improvement of the Targeted Jobs Tax Credit. A list of those companies is on the cover page of my statement before you.

Mr. Chairman, Borg-Warner and the other employer members of JOBS strongly support the retroactive and permanent extension of the targeted jobs tax credit as proposed by President Clinton. The program works -- and works efficiently in the way it was intended; that is, the delivery of jobs by private industry for workers who would otherwise remain unemployed.

Ten years ago, Borg-Warner took its first serious look at the Targeted Jobs Tax Credit program. TJTC has now actually induced our company to favor disadvantaged workers in recruitment, hiring, pay, and retention. The program within Borg-Warner moved from difficult beginnings with field units showing apathy, bias, and resistance, to a now mature program with widespread support and application. Over the years, Borg-Warner has consistently maintained one of the highest levels of TJTC participation of all manufacturing companies.

And, while the proposal by the President to expand TJTC to a new category of "youth apprenticeship" is appealing, our group strongly supports reinstating the category of 23 and 24 year olds which was eliminated in 1988. Our experience at Borg-Warner is that TJTC is especially helpful to the 23 and 24 year old category of potential workers.

Perhaps my own experience could help you better understand the success of TJTC in the real job market.

Borg-Warner Security Corporation is the nation's largest provider of security services. Our operations include two major providers of contract security guards -- Burns International Security Services and Wells Fargo Guard Services. Our other units are Wells Fargo Alarm Services, Wells Fargo Armored Service Corporation, and Pony Express Courier. We employ more than 85,000 through a nationwide network of approximately 575 branch offices.

The very nature of our business means that we actively recruit the most responsible, alert, and conscientious people possible. Why, therefore, should we preferentially hire less-skilled workers who often do not have an employment history?

The answer is that TJTC-eligible employees can certainly be very good employees if given the chance. And that chance has been provided through TJTC. At Borg-Warner, we found that the tax credit available through the program was sufficient incentive to alter our traditional employment practices. This is a key point, Mr. Chairman; the way we hire people now is much different than even ten years ago.

At Borg-Warner, TJTC is not administered by the tax department, accounting department, or personnel department. It is a business activity that is managed by the business unit head, just as they manage sales, inventories, and expense controls. Incentives to seek, hire, pay, and retain TJTC-eligibles are dispersed throughout the organization concentrated at the field level where the real work of recruitment and retention is carried out.

We began the program in 1982, and frankly, encountered a lot of resistance. However, by 1985 our company had hired and vouchered 6,619 TJTC-qualified employees -- one percent of all TJTC certifications issued nationwide. Cumulatively, during the past

ten years, Borg-Warner has recruited and hired over 61,000 TJTC-eligible employees. TJTC actually did cause us to change our employment practices.

You can see that Borg-Warner Security Corporation is serious about TJTC.

Mr. Chairman, your committee may hear critics of TJTC say that it only rewards employers for hiring workers they would have hired anyway. That has not been the case at Borg-Warner. When there was not a special incentive, our company simply did not hire many workers who would have been TJTC-eligible; the fact is recruiting them often requires much more time and effort. In 1983, Borg-Warner screened 2,800 TJTC eligibles from 52,000 new hires. In 1984, when we emphasized TJTC, our field office established partnerships with local referral agencies -- such organizations as Goodwill, the Urban League, and of course, state employment services. The results were dramatic. The number of screened eligibles rose to 3,400 in 1984 and 10,500 in 1985 -- over a three-fold increase.

In fact, by 1985, our divisions had refined their recruitment operations to a point where field units maintained weekly contact with an average of ten local referral agencies. Work relationships with agency personnel had matured to a point where weekly referrals were routine. Notable exceptions occurred where local unemployment rates were low, thereby preventing referrals of any workers, let alone TJTC-eligibles. One of the aspects of TJTC is that it works best where it is needed most. There are no bureaucracies to create programs at government expense for otherwise employable workers. Where eligibles have already found employment, TJTC is unnecessary and unutilized.

As indicated in our earlier employment statistics, Borg-Warner experienced a far more dramatic growth in TJTC hiring than that of total hiring. There is no doubt that TJTC actually did provide an incentive that changed how we hired workers.

Then, Mr. Chairman, a very interesting thing happened. In 1986, the number of TJTC-vouchered employees experienced an 88 percent drop. You may remember that was the year the program lapsed for ten months, much like it is now since the credit terminated June 30, 1992. Congress retroactively reinstated the credit, but in the interim most state employment agencies had eliminated TJTC vouchering because of the lack of consistent federal funding for administration.

That is one reason why the TJTC program should be made permanent; so that both agencies and employers can confidently plan for the program and establish on-going objectives.

Mr. Chairman, there are two other criticisms of the program which I would like to briefly address. The first is the criticism that TJTC is a minimum-wage program for dead-end jobs. Our experience challenges this, also. The average wage of all TJTC-vouchered employees at Borg-Warner Security is considerably higher than the minimum wage.

One of the premises of the targeted wage subsidy has always been that the hardest-to-employ are less skilled and therefore, at least initially, less productive than less disadvantaged workers. If employers recognized their lower productivity, targeted workers would be expected to earn less per hour than non-targeted workers. While internally studies done at Borg-Warner confirmed that TJTC workers were initially less productive than their non-TJTC counterparts, the workers turned out to be nearly the same in productivity after they had gained experience on the job, earning only slightly less, correspondingly, than non-TJTC workers.

Another concern about the TJTC program is whether it provides longer-term employment. There may be a tendency by observers to think of the targeted jobs tax credit as a hiring instrument. No doubt, it is first and foremost a vehicle for disadvantaged workers to use in getting jobs. This primary purpose, however, is not its exclusive purpose. As soon as the targeted worker is hired, the employer must take steps to maximize the duration of employment and the corresponding size of the subsidy. In fact, an employee retention study we commissioned internally found that TJTC-eligible security guards remained with us nearly three times longer than non-TJTC security guards. The study concluded that we should continue and expand our TJTC program.

Mr. Chairman, TJTC is a win-win program. The federal government wins because TJTC helps the hard-to-employ find jobs. Employers like Borg-Warner Security win because of the tax credit incentive to go the extra mile in recruiting. But most importantly, the TJTC-eligible employees win when they are given a chance where none existed before.

We urge you to retroactively and permanently extend this vital program.

Thank you.

Mr. LEWIS. Thank you, Mr. Trauscht.
Ms. Hall.

STATEMENT OF PAULETTE HALL, EXECUTIVE DIRECTOR, OFFICE OF EMPLOYMENT SERVICES, MARYLAND DEPARTMENT OF ECONOMIC AND EMPLOYMENT DEVELOPMENT

Ms. HALL. Mr. Chairman and members of the Ways and Means Committee, my name is Paulette Hall, and I am the executive director of the employment service for the Department of Economic and Employment Development in Maryland.

I would like to take this opportunity to thank you for giving us the opportunity to address you concerning how TJTC has assisted us in assisting members of the Herman L. Toulson Correctional Boot Camp to obtain employment.

The boot camp was established in August 1990 by Maryland's Governor, William Donald Schaefer, as an alternative incarceration facility for youthful offenders who have committed first-time, nonviolent offenses. This voluntary program offers inmates freedom after 6 months of highly structured and disciplined experiences. Guided by the three major components of the boot camp, discipline, work, and education, inmates participate in calisthenics, military drills, work details, educational classes, counseling, and employment readiness.

Inmates numbering 772 have successfully completed the boot camp since 1990. The cost of incarceration of boot camp graduates is $9,000 per 6-month term, and the recidivism rate is approximately 14 percent.

The need for boot camp aftercare programs was brought to the attention of various State agencies by the Governor's Commission on Black Males. Book camp aftercare programs have been established in Baltimore City and Prince Georges County, MD. Additional programs are forming across the State.

Programs for boot camp graduates include networking with existing community services for substance abuse treatment, educational and training assistance, employment readiness, and group support.

The Maryland Job Service tied the TJTC Program in with the Aftercare program. We hired staff under TJTC funding to provide services to boot camp graduates and other ex-offenders. These services include job development activities and the promotion of TJTC and the Federal bonding programs as incentives for employers to hire boot camp graduates.

The employment readiness training sessions are conducted by the staff that we hired under TJTC, and they begin 30 days prior to graduation from the boot camp. The graduates are taught to market themselves using job service resources, such as the automated labor exchange and to use the TJTC and Federal bonding programs. Additionally, graduates receive exposure to entrepreneur activities and college courses.

TJTC-funded staff are colocated in the aftercare facility in Baltimore City with parole and probation officers, providing one-stop services to the boot camp graduates. Feedback from employers indicate that TJTC is an effective tool for promoting the hiring of graduates.

Also, the graduates feel that they have tools and incentives that open doors and offers them opportunities for employment. Our experiences with the boot camp graduates have been positive. We have vouchered 347 since we have been working with this project, and 211 certifications or hires have occurred.

This is but one example of how the State of Maryland proactively uses TJTC to market job seekers who have barriers to employment. We voucher an average of 29,000 applicants from all target groups per year, and an average of 20,000 of those individuals are certified or hired. We have received approximately 27,000 letters of request from employers seeking certification since July 1 of 1992.

I would like to end by saying we appreciate the opportunity to share with the committee how Maryland Job Service uses TJTC to serve boot camp graduates. We believe it is one of the most important uses of TJTC.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAULETTE HALL, EXECUTIVE DIRECTOR, OFFICE OF EMPLOYMENT SERVICES, MARYLAND DEPARTMENT OF ECONOMIC AND EMPLOYMENT DEVELOPMENT

Mr. Chairman and members of the full Committee on Ways and Means, I would like to thank you for the opportunity to address you on the Targeted Jobs Tax Credit (TJTC) program and its role in placing graduates of Maryland's Herman L. Toulson Correctional Boot Camp in meaningful employment.

HERMAN L. TOULSON CORRECTIONAL BOOT CAMP AFTERCARE PROGRAM

Hoping to reduce the cost of incarceration, Governor William Donald Schaefer established the Herman L. Toulson Correctional Boot Camp on August 6, 1990. The Boot Camp is an alternative incarceration facility for youthful offenders (18-32 years old) who have committed first-time, non-violent offenses. This voluntary program offers inmates freedom after six months of highly structured and disciplined experiences focusing on self esteem and control, values and a sense of teamwork. The program works on changing attitudes toward themselves, society in general and toward criminal behavior. Guided by the three major components of the Boot Camp, discipline, work and education, inmates participate in calisthenics, military drills, work details, educational classes, counseling and employment readiness training.

Seven hundred and twenty-two (722) inmates have successfully completed the Boot Camp. One hundred and three (103) inmates (14 percent) have been revoked by the Parole Commission and returned to prison as of January 1, 1993. Of these, twenty-eight (28) committed new crimes and the remaining failed due to technical violations and absconding. Warrants have been issued for an additional 106 offenders, with the vast majority (78) being cited for technical violations only.

The recidivism rate for Boot Camp graduates is considerably lower than traditional penal facilities, where recidivism runs as high as 60 percent, according to the National Institute of Criminal Justice and the Maryland Department of Corrections. This means that for every three offenders released from a traditional prison, two return for committing new crimes. These statistics indicate that alternative programs, like the Boot Camp, can work and that they can reduce the cost of incarceration. The approximate cost of incarcerating an inmate at the Boot Camp is $9,000 per six-month term as compared to the $30,000 per year it costs at other prisons.

The need for employment readiness assistance for graduates of the Herman L. Toulson Correctional Boot Camp was brought to the Maryland Department of Economic and Employment Development's attention as a result of a visit to the Boot Camp by members of the Maryland Governor's Commission on Black Males. State Delegate Elijah Cummings of the 39th District, Baltimore, Maryland, who chairs the Commission, held public meetings for the Commission at several of Maryland correctional institutions, including the Herman L. Toulson Correctional Boot Camp.

The public meetings led to the formation of an Aftercare Program for Boot Camp graduates. The Department of Public Safety and Correctional Services considers the Aftercare program as one of the components in its continuing efforts to reduce the recidivism rates of Boot Camp graduates.

<u>**Purpose:**</u>	To provide follow-up services to graduates of the Boot Camp Program.
<u>**Management:**</u>	A plan of services is developed and coordinated by Advisory Groups chaired by State Delegate Elijah Cummings for Baltimore City and by State Senator Decatur Trotter for Prince George's County.

Graduates' Responsibility:	Graduates are responsible for an eight-point contract with parole and probation. One of the conditions requires graduates to be employed or in school full-time within 60 days of their release from the Boot Camp. Additionally, they are responsible for participating in the activities under the Aftercare Program.
Program:	Networks existing community services, such as substance abuse treatment, educational and training assistance, employment readiness, job development and placement services and entrepreneurial training.
Locations:	St. Ambrose, Park Heights and Wiley avenues, Baltimore, Maryland Lighthouse Pentecostal Church, Hampton Mall, Prince George's County, Maryland

Maryland's Job Service has always looked for creative and innovative ways to use TJTC in placing members of targeted groups. To that end, we tied the TJTC program in with the Aftercare program. In September of 1991, the Maryland Job Service hired a staff of two under TJTC program funding to provide services to Boot Camp graduates and other ex-offenders. With the help of the College Park Job Service Office, this staff also provides support to the Boot Camp program in Prince George's County.

The TJTC funded staff are responsible for Job Development activities that promote TJTC and the Federal Bonding programs as incentives to hire Boot Camp graduates. Employment Readiness Training sessions are held at the Boot Camp 30 days prior to graduation and twice a week at the Aftercare facilities following graduation. During the sessions, Boot Camp graduates are taught how to market themselves to employers using the TJTC and Federal Bonding incentives. Additionally, Boot Camp graduates receive exposure to entrepreneurial activities through the Maryland Business Owners Start-Up Service (BOSS) program.

- 347 Boot Campers were vouchered.

- 211 Boot Campers were certified (hired for TJTC).

EMPLOYER FEEDBACK

Feedback from employers such as the Marriott Corporation; Lenmar Paints; David N. Edwards, LTD; Parks Sausage Co.; and the International House of Pancakes indicate that TJTC is an effective tool for prompting the hiring of graduates of the Herman L. Toulson Correctional Boot Camp.

> "Boot camper employees are motivated, reliable, hardworking and able to handle stress."

> "The TJTC program made a significant difference. It lessened the company's liability and allowed the company to hire an ex-offender when we would not have otherwise."

> "TJTC offsets the cost of training and makes the risk of hiring an ex-offender worthwhile".

GRADUATE FEEDBACK

Ex-offenders often question whether they can gain access to the mainstream. Many do not want to face the rejection they may receive from employers as they attempt to find employment. They feel that employment readiness training, which teaches them how to prepare for the interview, how to market themselves, how to use TJTC incentives as a marketing tool, and how to use the Maryland Job Service resources such as the computerized Job Bank system, helps to open doors to employment opportunities.

TARGETED JOBS TAX CREDIT AND THE WAY IT IS USED IN MARYLAND

In the way of background, let me say that the Maryland Job Service made an early commitment to use the Targeted Jobs Tax Credit as a proactive tool to sell applicants to employers and we have successfully continued that philosophy up to the program's expiration on June 30, 1992.

That philosophy is best exemplified by our performance. We identify and voucher 28,000 to 30,000 applicants per year and assist 18,000 to 22,000 of those individuals into jobs.

- Sixty-five percent of those jobs are in the $5.00/hour and above range.
- Thirty-four percent are in the service industry, as it is generally defined (fast food, janitorial, etc.).
- Twenty-seven percent are in miscellaneous blue collar fields, which include factory assembly line, food processing and fisheries.
- Twenty-one percent are in clerical and sales jobs.
- The professional and technical, skilled trades and construction areas each account for six percent.
- Our average cost per placement certification is $27.26.

These results by the Maryland Job Service are examples of what is occurring in this program in states across the country. Our experience clearly demonstrates that TJTC is a valuable and cost effective strategy when used in conjunction with Job Service resources. It encourages employers to hire job seekers with barriers to employment like our Boot Camp graduates.

The Maryland Job Service's overall experience with ex-offenders under TJTC has been a positive one. In 1991, 2,841 ex-offenders were vouchered and 1,759 ex-offenders were certified. For the first six months of 1992, 2,097 ex-offenders were vouchered and 1,260 ex-offenders were certified. In the last six months of 1992, 1,343 letters of request for certification have been received from employers who have hired ex-offenders in anticipation of the retroactive renewal of TJTC.

Since July 1, 1992, we have received nearly 27,000 letters of request from employers seeking to have eligibility determinations of job seekers made in the hope that this tax credit will be reauthorized retroactively as it has been following its expiration during all previous years. We are aware that other states have been getting requests from employers for the continuation of TJTC and that their employment service agencies are anxious for the renewal of TJTC so it can continue to be used as a selling tool in the placement of job seekers.

I would like to end by saying we appreciate the opportunity to share with the Committee how the Maryland Job Service utilizes TJTC to serve ex-offenders. We believe it is one of the most important uses of TJTC.

Mr. LEWIS. Thank you, Ms. Hall.

Ms. Rowell-Williams and other members of the panel, let me just ask: Except for the use of job service officers and community-based agencies and organizations, what are some of the other common recruiting methods that you use to be sure that you are hiring the people, that you are reaching the people that are eligible? I know you must not ask people certain questions when you are interviewing. So how can you be sure that you are reaching the right people?

Ms. ROWELL-WILLIAMS. Well, at Taco Bell, we use various agencies, such as private industry councils, to actually seek out TJTC candidates, and once the employees actually come on board with the company, we use a third-party consulting firm to screen our employees for TJTC eligibility.

Mr. LEWIS. Do you know whether that third party raises these questions? It is not legal to ask a possible hire, a potential new hire, certain questions, right?

Ms. ROWELL-WILLIAMS. There are a series of questions that the consulting firm will go through with the employee. They are standard questions, and they are all legal to ask the employee if they actually qualify or not.

Mr. LEWIS. Would other members of the panel like to comment?

Mr. TRAUSCHT. Mr. Chairman, we do exactly the same thing. We go to organizations such as Goodwill or the State employment agencies and ask them to send us people. We use a third party to screen those people for eligibility, and once we receive approval from the various States, we put the people on board and begin to train them. And we use a mentor system inside the company internally to make sure those people progress well in their jobs. It truly does get people who are on the dole, so to speak, back in the active life, and I think it adds a lot of dignity to what they do in this world today.

Mr. LEWIS. Thank you.

Mr. Grandy.

Mr. GRANDY. No questions.

Mr. LEWIS. Mr. Hancock.

Mr. HANCOCK. No questions.

Mr. LEWIS. Let me just thank this panel for your testimony, for your statements. Your complete statements will be made part of the record.

You all have been great witnesses. You all are great believers in this program.

Thank you very much.

Mr. LEWIS. Will the next panel come forward. Mr. Belcaster, Mr. Stimpson, Mr. Mann, Mr. Brandt, and Mr. Chapler.

As I have said to the panels before you, it is our desire that you be brief, and you can summarize your statement and submit your complete statement for the record. When the red light comes on, that means to stop.

We will start with you, Mr. Belcaster.

STATEMENT OF ROBERT BELCASTER, PRESIDENT, CHICAGO TRANSIT AUTHORITY, ON BEHALF OF AMERICAN PUBLIC TRANSIT ASSOCIATION

Mr. BELCASTER. Thank you, Mr. Chairman and members of the committee.

My name is Robert Belcaster. I am president of the Chicago Transit Authority. The CTA is the second-largest transit system in the United States. We thank you for both my presence here today and to represent the American Public Transit Association, which represents about 95 percent of all users in the United States.

Mr. Chairman, with your help, the transit industry can again be an economic engine. We can create jobs, eliminate transportation bottlenecks that lessen productivity, and help clean up the air. We can help reduce the demand for imported oil that drives up our trade deficit and allow our major business zones to function effectively. I think that is a point that needs to be understood about transit. We are an engine for major business zones.

A critical step is to extend the 2.5-cents-per-gallon Federal gas tax that expires in 1995 and deposit it in the Highway Trust Fund.

We are very pleased that Secretary Peña has proposed to extend the 2½-cent tax and fully support the half-cent that he is proposing for transit. This is good public policy for several reasons. First, the Mass Transit Account needs the revenue. APTA estimates that without the additional revenue, the Mass Transit Account will fail the "Rostenkowski Test" by 1999 and possibly earlier once the full cost of the Americans with Disabilities Act requirements are well-understood.

As I have recently learned, the "Rostenkowski Test" says that the estimated amount of commitments in excess of cash balances may not exceed the estimated receipts for the following fiscal year.

This assumes the appropriators will spend the full amount that ISTEA authorizes to be taken from the Mass Transit Account. That is a good assumption.

In fiscal year 1993, nearly 96 percent of the funds authorized from the MTA were appropriated, and please recall that the ADA costs are not yet being fully funded.

The 2½ cents with the 80/20 historical split will see the Highway Account and the Mass Transit Account through the ISTEA authorization period. In later years, both accounts will require more revenue.

Maintaining at least the historic 80/20 relationship for transit is an important sign of the administration's commitment to the benefit that transit provides the entire Nation and recognizes our responsibility to assist corporations in their trip reduction requirements that are required in the non-attainment areas and to fund improvements giving main-line accessibility to the disabled.

In 1983 and 1990, the Mass Transit Account received 20 percent of the increase in the gas taxes designated for the Highway Fund. In 1991, your committee reaffirmed the 20-percent minimum when extending the 1983 and 1990 tax increases in title VIII of ISTEA.

At a time of growing concern about air pollution, dependence on foreign oil, and traffic gridlock, we cannot afford to retreat on these issues, nor can we forget that transit is the key to solving them. If transit fails, there will be business stagnation, not gridlock.

As your committee looks at this issue, we urge you to respond to transit and highway needs in a way that balances Federal priorities and mandates, always keeping in mind that major business and Government centers depend on transit.

On a similar front, APTA supports legislation to exempt commuter railroads from the 2.5-cent-per-gallon excise tax on diesel fuel passed in 1990. Commuter rail should be exempt, as are other transit agencies.

The transit industry appreciates the inclusion of this exemption in the House of Representative bill 17 and hopes it is enacted.

Additionally, Mr. Chairman, we are concerned about the proposed Btu tax. APTA estimates that this tax will add approximately $100 million to the annual operating expenses of transit agencies. Our costs are funded approximately 40 percent from the fare box and 60 percent by the States. In essence, therefore, a $100 million Btu tax is actually a $60 million tax on the States. That is quite an ironic result.

If we are forced to pass on the cost of this Btu tax to both our States and our customers, these will be in the form of higher fares or service cutbacks, making it impossible to increase ridership, save energy, and reduce pollution.

Mr. Chairman, I want to close by thanking your committee for your leadership in passing the transit pass legislation last year. This $60-per-month, tax-free benefit will see good promise in the years to come.

Thank you.

[The prepared statement and attachments follow:]

STATEMENT OF THE AMERICAN PUBLIC TRANSIT ASSOCIATION

INTRODUCTION

Mr. Chairman and Committee members, my name is Robert Belcaster. I am the President of the Chicago Transit Authority in Chicago, Illinois. The CTA is the second-largest public transportation system in the United States.

Thank you for giving the American Public Transit Association (APTA) this opportunity to testify on economic stimulus legislation, transit funding sources and needs, and related tax issues. APTA represents transit systems that provide about 97% of our nation's mass transit services as well as many of the manufacturers and suppliers who provide goods and services to the industry.

The U.S. transit industry is a powerful tool for economic growth. We serve more than 10 million customers each weekday, and our riders make a total of 8.6 billion trips each year. Transit agencies employ 282,000 workers who receive compensation of $11.5 billion annually. We support thousands of other jobs for workers in transit equipment manufacturing firms and other transit-related businesses, construction workers on transit capital projects, and employees in all sectors of the economy.

These figures reflect the transit industry's contribution to our economy today, after a decade of neglect at the federal level. Tomorrow, with the right combination of federal tax and investment policies, our industry can do much more to sustain economic growth and improve productivity by eliminating transportation inefficiencies. If transit reaches its full potential, all Americans will benefit from higher employment, more efficient movement of people and goods, a greater range of convenient transportation choices, cleaner air, greater energy security, reduced congestion, and improved quality of life in our cities, suburbs, and rural areas. For these reasons, we thank the Committee for its past, and we hope future, efforts to adopt tax policies that promote transit use and we urge you to keep up the good work.

The Federal Gasoline Tax

APTA strongly favors extending the 2.5 cents per gallon federal excise tax on gasoline that is due to expire at the end of September 1995. We believe that this tax, now earmarked for deficit reduction and deposited in the General Fund, should be dedicated to transportation and deposited in the Highway Trust Fund (HTF). At least 20 percent of this tax, or one-half cent per gallon, should be designated for the Mass Transit Account (MTA) of the Highway Trust Fund.

We are very pleased that Transportation Secretary Peña has proposed to extend the 2.5 cents gasoline tax and dedicate it to the Highway Trust Fund with an 80/20 split between the Highway Account and the Mass Transit Account -- 2.0 cents for the Highway Account and a half-cent for the Mass Transit Account. We welcome Secretary Peña's decision to uphold the traditional 20 percent for the Mass Transit Account and we urge this Committee to support him.

We do, however, have concerns about proposals to let the Highway Account "borrow" from the Mass Transit Account if the Highway Account balance falls below a certain level. We urge that the two Accounts not be commingled in this way, and that safeguards be implemented to help separate them.

Dedicating at least a half-cent to the Mass Transit Account is good public policy for three reasons.

* First, the Mass Transit Account requires the revenue.

* Second, maintaining at least the historic 20 percent minimum for transit is an important sign of the Administration's commitment to the national priorities that are the basis for federal transit funding.

Mass Transit Account Revenue Needs

A second reason for giving a half cent to the Mass Transit Account is to provide a reliable source of revenue to the Account. Congress will have to address the issue of MTA funding stability because it is virtually certain that 100 percent of funds authorized from the MTA will be appropriated. Without additional revenue, the MTA will have difficulty meeting its statutory test of solvency, the Rostenkowski Test.

The Rostenkowski Test, the Mass Transit Account equivalent to the Byrd Amendment requirement, states that the estimated amount of commitments in excess of cash balances may not exceed the estimated net receipts in the next fiscal year. The Byrd Amendment establishes a similar requirement for the Highway Account, except that the estimated commitments in excess of cash balances may not exceed the estimated net receipts for the next two fiscal years.

APTA estimates that, without additional revenue, the Mass Transit Account's committed balance will exceed its cash balance in FY 1998, and the MTA will fail the Rostenkowski Test in FY 1999. [See Figure 1.] This estimate assumes full funding of the transit program authorized in ISTEA, a very reasonable assumption with respect to the part of the program funded from the Mass Transit Account.

The federal transit program has two funding sources, the Mass Transit Account and the General Fund. For the remainder of the ISTEA authorization period, from FY 1994 through FY 1997, APTA's highest legislative priority is full funding of the entire program, including the components funded from the Mass Transit Account and those funded from general revenues.

Even under a less-than-full funding scenario, however, it is highly probable that the appropriation of Mass Transit Account funding will reach the full authorized amount. In FY 1993, nearly 96 percent of funds authorized from the MTA were appropriated. Only 37 percent of funds authorized from the General Fund were appropriated, and this accounts for virtually all of the $1.6 billion shortfall in overall funding.

There is another reason why there will be intense pressure to appropriate the entire authorized MTA funding level. This is the growing need for Section 3 Discretionary New Start funding for major capital projects. ISTEA includes specific authorizations for 48 New Start projects in 23 states, with total federal funding of $6.112 billion. So far, $1.152 billion has been appropriated for these earmarks, leaving a $4.96 billion New Start funding requirement in FY 1994 through FY 1997. As work on these projects goes forward, the demand for New Start funding has nowhere to go but up.

In FY 1994-1997, the Mass Transit Account is authorized to provide from 81.2 percent to as much as 99.3 percent of the authorized Section 3 discretionary program. To the extent that these major capital projects continue to have support in Congress, there will continue to be pressure for MTA appropriations to reach the full authorized level.

We urge the Committee to support additional revenue for the Mass Transit Account because this aspect of our legislative agenda falls within your jurisdiction, but we want to assure you that we will continue to press for full funding of both the Mass Transit Account and General Fund components of the federal transit program. The success of the federal transit program depends on full funding of every individual authorized part, including the Section 18 Non-Urban program, the Section 16(b) Elderly/Disabled Program, and the Section 9 Urban capital and operating assistance programs.

Dedicating 2.0 cents per gallon to the Highway Account, 80 percent of the 2.5 cents, would provide more than sufficient revenues to cover the Highway Account's anticipated expenses. The enclosed chart, prepared by the Clinton administration, shows that the revenue from 2.0 cents per gallon of the tax would give the Highway Account a positive balance throughout the entire ISTEA authorization period. The positive balances are in the line titled "Byrd Test Headroom."

After the ISTEA authorization period ends in FY 1997, account solvency issues do arise for both the Mass Transit Account and the Highway Account. Even with the additional revenue from the half cent, we project that the committed balance of the Mass Transit Account will exceed the cash balance in FY 1999. The MTA would fail the Rostenkowski Test in FY 2001.

With the revenue from 2.0 cents per gallon, the Highway Account faces a Byrd Amendment problem in FY 1998. Even if the Mass Transit Account's half cent were turned over to the Highway Account, the problem would only be postponed for a year, until FY 1999. Given the damaging effect on the Mass Transit Account, it makes little sense to consider an option that would only serve as a stop-gap response to the Highway Account's funding problem.

We hope to work with the Committee as it looks at ways to provide stable funding for the Highway Trust Fund, to find solutions to any potential shortfall to the Mass Transit and Highway Accounts.

Upholding a Wise Precedent

We believe that the need to uphold local flexibility and to guarantee additional Mass Transit Account revenue are compelling reasons to designate one half cent to that Account. But another problem would arise if, as some have proposed, the Mass Transit Account received less than 20 percent of the revenue from the 2.5 cents. Allocating less than 20 percent to the Mass Transit Account would break a precedent established during the Reagan administration and maintained during the Bush administration. In 1983 and again in 1990, the Mass Transit Account received 20 percent of the increase in gas taxes designated for the Highway Trust Fund. In 1991, your Committee reaffirmed the 20 percent minimum when extending the 1983 and 1990 tax increases in Title VIII of ISTEA.

The 20 percent minimum must be reaffirmed because of what it says about the federal government's determination to support transit. Anything less would suggest a weakening of the federal commitment to encourage transit and other high-occupancy modes of travel that are essential to clean up the air, reduce energy use, control traffic gridlock, rebuild our cities, and meet the mobility needs of all Americans.

As noted in recent General Accounting Office testimony to the Senate Transportation Appropriations Subcommittee [*Mass Transit: FTA's Projections Could Better Reflect State and Local Needs*, March 11, 1993], the $90.8 billion figure for six-year capital requirements could be understated because it does not fully account for:

> "(1) costs for transit vehicles to convert to alternative fuels, due to clean air or energy conservation requirements; (2) ADA requirements to make existing transit stations accessible to persons with disabilities and to provide expanded special services for the disabled; and (3) expanded transit services to meet specific transportation-related goals, such as reduced traffic congestion or improved air quality."

Right now, local authorities are making critical decisions on Clean Air Act compliance strategies, and there is growing concern about worldwide environmental problems. We cannot afford to retreat from this federal commitment to environmental protection.

Commuter Rail Diesel Tax Exemption

Traditionally transit systems have been exempted from paying federal excise taxes on fuel. **APTA supports legislation to exempt commuter railroads from the 2.5 cent per gallon excise tax on diesel fuel passed in 1990.** That year's budget reconciliation act exempted other transit systems from this tax, but, in what APTA believes was an oversight, commuter railroads were required to pay the tax.

Under this Committee's leadership, Congress last year passed legislation to correct this mistake as part of a tax bill vetoed by President Bush. APTA favors the passage of legislation to exempt commuter rail operators from this tax. Any new taxes are passed on in the form of higher fares, which act as a barrier to increased ridership. Mr. Chairman, the transit industry appreciates your inclusion of this repeal in H.R. 17, and we hope the repeal will be enacted soon.

Broadbased Energy Tax (Btu) Tax

Like every sector of the economy, the transit industry will be affected by the Administration's proposed tax on the British thermal unit (Btu) content of energy sources. APTA estimates the federal Btu tax will add approximately $100 million to the annual operating costs of transit agencies. This is a major increase for the public agencies that provide transit service. As with all publicly operated agencies facing budgetary restraints, a Btu tax will only exacerbate budgetary problems at the local level.

The Administration points to the tax as a means of reducing U.S. dependence on imported oil and limiting vehicle emissions. In each case, transit's chief contribution is to provide an alternative to the single-occupant vehicle, the mode of transportation that causes the lion's share of the problem. Any federal policy that makes transit less competitive will be counterproductive. The Btu tax will increase transit operating costs. As these costs are passed on to customers -- whether as higher fares or service reductions -- it will hinder the transit industry's ability to increase ridership and thereby save energy and reduce air pollution. As the Committee sorts out the possible consequences -- intended and unintended -- of the Btu tax, we hope you will remember the many assignments that the federal government has already given to the transit industry.

Transit Pass

Mr. Chairman, we want to thank you and the Committee once again for your leadership in shepherding to enactment the transit pass legislation included in the Comprehensive National Energy Policy Act, P.L. 102-486. This law provides that, as of January 1, 1993, employers can provide employees up to $60 per month in transit benefits -- nearly triple the $21 per month that was previously allowed -- or a $60 per month benefit for employees who commute in "commuter highway vehicles" such as vanpools and commuter buses. The new law also caps nontaxable employer-paid parking at $155 per month, so that parking benefits in excess of that amount must be counted as income to the employee.

This is good public policy because it extends a benefit to people who depend on transit, many of them lower-income workers, and it rewards those who choose to use transit and thereby do their part to clean up polluted air, save energy, and reduce traffic congestion.

This law has excited a great deal of interest all across the nation, and APTA has received hundreds of inquiries about the new transit pass benefit. We are working with the Association for Commuter Transportation (ACT) and the Federal Transit Administration to ensure that the transit pass reform law is successfully implemented. Our goal is to educate employers and commuters about the new law, to provide technical assistance to transit agencies and employers, and to disseminate information about successful local transit pass programs. Because increased use of transit and carpooling will be more and more important in areas with air pollution problems, we hope to focus attention on the urbanized areas with the most serious non-attainment problems, including the New York, Chicago, Los Angeles, Houston, and Philadelphia metropolitan areas.

One possible refinement of the law would be to require the inclusion of transit pass and vanpool benefits in "cafeteria benefit" programs offered by employers. We hope to work with the Committee on this and other ways to ensure that the transit pass law fulfills its promise.

We also want to alert the Committee to one possible issue that may arise as the Internal Revenue Service develops regulations pertaining to this law. We believe that Congress intended this proposal to encourage people to use all forms of transit , including driving to park-and-ride lots at bus and rail terminals.

To encourage park-and-ride commuting, employers may wish to provide an employee with up to $60 per month in transit pass benefits and up to $155 per month in parking benefits. We hope that the IRS regulations will recognize that Congress intended to encourage park-and-ride commuting as well as other forms of transit and shared-ride services.

Setting Transportation Prices Fairly

The transit pass reform law is a significant first step in creating a level playing field between transit riders and drivers of single-occupant vehicles. Other government policies, however, continue to subsidize single-occupant vehicles. One effect is to inhibit the use of transit, but society and the economy pay many other costs:

* Excessive demand for roads and highways means endless increases in congestion;

* Total vehicle emissions are beginning to climb in large part because the cost of driving does not reflect the cost to society of an individual vehicle's emissions;

* Oil consumption is on the rise, adding to the trade deficit and complicating the task of safeguarding our national security; and

* Auto-induced sprawl raises the tax bill for more roads, utility lines, sewers, and other infrastructure costs that taxpayers must pay for new development.

The pump price of gasoline does not reflect the costs of pollution, congestion, excessive energy use, and other effects of driving. The World Resources Institute has estimated that drivers pay for only about 13 percent of the public costs of highway transportation -- we all pay the remaining 87 percent in our tax and medical bills, in inconvenience, and in diminished quality of life, but without any label showing that highway travel costs are responsible.

The cost of gasoline, in today's dollars, is nearly a dollar per gallon less than it was just over a decade ago, and 40 cents per gallon less than in 1950. The U.S. has by far the lowest gas tax rate of any Western industrial economy. The average rate for Japan and five European industrial countries is six times ours. Little wonder, then, that per capita fuel consumption is three to four times greater in the U.S. than in other nations.

We in transit believe the Committee should seriously consider fair increases in the federal gasoline tax to levels that recognize the high hidden costs of gasoline consumption, as a way to further balance our transportation system and guarantee its efficient operation. A gas tax increase, with all or part of the revenues dedicated to transportation purposes, would reduce the trade deficit and promote conservation and cleaner air by discouraging drive-alone commuting.

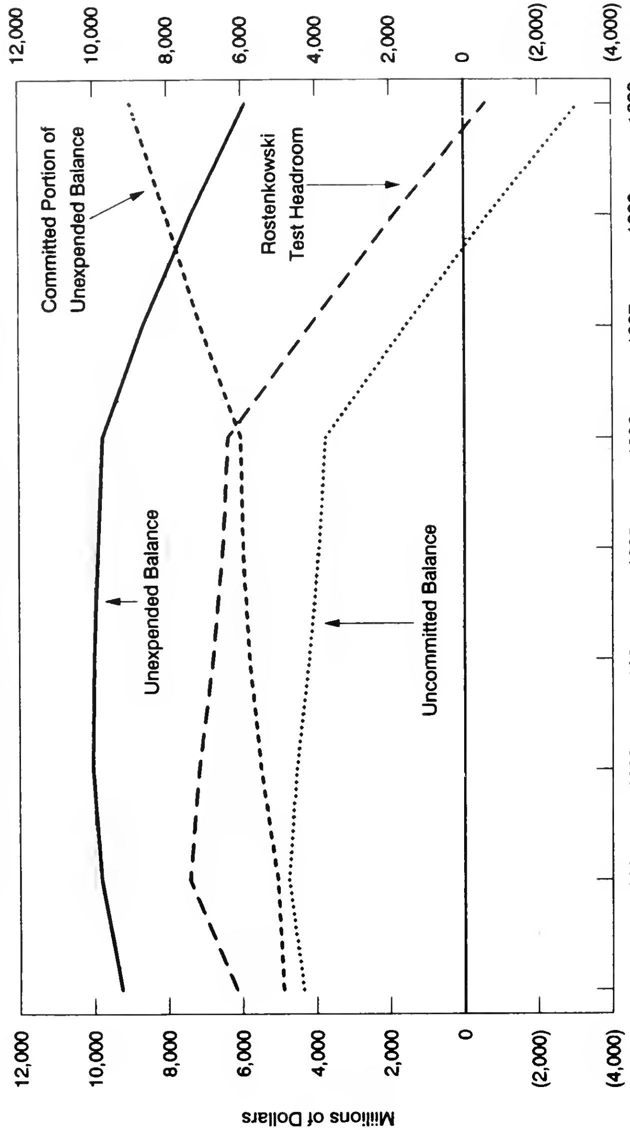
Conclusion

Mr. Chairman and members of the Committee, your decisions on these tax issues can make the difference between stagnation for the U.S. transit industry or a new era in which transit increases its ridership by providing a modern, efficient alternative to single-occupant vehicle commuting. We ask for your support so we can do our part in improving productivity, providing all Americans with accessible transportation, creating jobs, cleaning up polluted air, reducing dependence on imported oil, and protecting the quality of life in urban, suburban, and rural communities throughout the nation.

Figure 1: Estimated Balances of the Mass Transit
Account of the Highway Trust Fund

(Amounts at End of Fiscal Year)

**** * At Current MTA Tax Rate of 1.5 Cents * ****



1994 PRESIDENT'S BUDGET HIGHWAY ACCOUNT (HA) OF THE HIGHWAY TRUST FUNDHPRSBUD4 / C CLASEN 8-MAR-93
2.0¢ GEN FUND FUEL TAX SHIFTS TO HTF IN 1996 ($ Millions)

	1991	1992	1993	1994	1995	1996	1997	1998
Federal-Aid Highways Budget Authority	14,014	17,521	20,670	20,872	20,897	20,927	20,994	21,512
				Total FAH BA, 1992-Yr this col =			121,881	
Federal-Aid Highways Obligations	16,269	17,661	20,645	20,515	20,701	20,874	20,979	21,516
Federal-Aid Highways Obligation Limitation	14,500	16,055	18,303	18,398	18,453	18,537	18,578	19,036
		1993 SUPP	2,976	Total FAH LIM, 1992-Yr this col =			108,324	
Budget Authority (HA)	14,336	17,664	21,377	21,338	21,369	21,428	21,503	22,034
				Total BA, 1992-Yr this col =			124,661	
Obligations (HA)	16,674	18,294	21,339	21,014	21,223	21,376	21,518	22,027
				Total OBS, 1992-Yr this col =			124,764	
Outlays (HA)	14,686	15,518	18,018	20,275	20,210	20,541	20,874	21,150
				Total OL, 1992-Yr this col =			115,436	
¢ Increase 2.00 / 1st Year 1996								
Revenue (Taxes) (HA)	14,494	15,664	15,847	16,258	16,541	19,371	19,892	20,204
				Total TAX, 1992-Yr this col =			103,573	
Outlays less Taxes	193	-146	2,171	4,017	3,669	1,170	982	946
Interest (HA)	810	908	819	634	378	180	126	79
Income (Taxes + Interest) (HA)	15,303	16,572	16,666	16,892	16,919	19,551	20,018	20,283
				Total INCOME, 1992-Yr this col =			106,618	
Cash Balances (HA)	10,246	11,300	9,946	6,866	3,274	2,284	1,427	560
OVERCOMMITMENT, Commitments in Excess of Cash Balances	21,943	23,284	27,995	32,442	36,693	38,770	40,255	42,007
Byrd Test Headroom	11,295	10,274	5,616	4,027	2,676	1,530	579	-658
Annual Reduction in CA Release for Byrd Amdmt (If Req'd)			None	None	None	None	None	-656
OUTLAYS (TF + GF), FHWA + NHTSA	14,912	16,021	19,151	21,674	20,661	20,696	20,926	21,174

Mr. LEWIS. Thank you very much, Mr. Belcaster.

Before I recognize the next member of the panel, let me just turn the Chair over to my friend and my colleague, Mr. Hoagland.

I recognize Mr. Stimpson.

STATEMENT OF EDWARD W. STIMPSON, PRESIDENT, GENERAL AVIATION MANUFACTURERS ASSOCIATION

Mr. STIMPSON. Thank you, Mr. Chairman.

I am Edward W. Stimpson, president of the General Aviation Manufacturers Association, representing U.S. companies that manufacture business, commuter, and personal aircraft, engines, avionics, and component parts. The aircraft our companies manufacture are 19 seats or less and carry over 120 million people a year in our Nation's air transportation system.

In terms of airplanes produced, 1992 was the industry's worst year since World War II. Only 899 aircraft were delivered. This is in contrast to nearly 18,000 airplanes that were delivered back in 1979. Clearly, our industry has never experienced economic recovery, and we anticipate that 1993 is going to be another challenging year.

Despite these difficult economic times, the U.S. general aviation industry has continued to invest heavily in new products and new technology. Within the next 5 years alone, over $1 billion will be spent on new aircraft development. However, the most important element for the health and vitality of our industry is a growing and expanding domestic and global economy, since over 40 percent of our airplanes are exported.

We have a 4-point program to reinvigorate our industry: reenactment of investment tax credit, repeal of the luxury tax on airplanes, product liability reform, and continued improvement of aviation infrastructure. Today, I will just touch on the tax issues.

We were encouraged by President Clinton's statements about the investment tax credit being a key element in the stimulus package. However, we fear that the President's tax package will not realize the goals intended.

Historically, the investment tax credit has stimulated growth in our industry and has been an important incentive for our customers to invest. After the ITC has been enacted or reenacted, our sales, industry billings, on new aircraft have gone up 30 percent in the first year and 50 percent in the second year. As a result, thousands of jobs have been created. A chart showing the historic impact of the ITC is in the back of the statement.

The ITC has been successful in the past for two important reasons: the potential buyer understood it, and it was a significant value. The incremental aspects of the proposed ITC does not meet this criteria. It is too complex and has too many qualifications to be easily understood by our customers.

Even for those who may choose to use the incremental ITC, its real economic value is only about 1½ percent, rather than the 7 percent. Thus, it is difficult for our customers who could qualify for the ITC to see any significant value.

On the other hand, the proposed small business ITC could provide a more meaningful benefit because it is simpler to understand and it has a greater economic value. We would urge this committee

to improve the administration's proposal and make the ITC both simpler and of greater value. This will make it a much more effective tool and economic stimulus.

Although the luxury tax was not included in the administration's proposal, we are heartened by the statements that the President supports repeal. We urge you to use the language included in H.R. 11 last year.

The luxury tax has depressed sales in new business aircraft. Instead of buying new aircraft, customers have bought used aircraft and have consequently avoided the luxury tax. As a result, millions of dollars in new aircraft sales have been lost.

Tax revenues generated by this tax are small compared to the negative impact in lost sales and jobs. In calendar year 1991, this tax brought in merely $119,000. For the first three quarters of 1992, $139,000 was raised. We are losing potential sales every week. It would be very helpful if the Congress would assure our customers that repeal of the luxury tax will be effective January 1, 1993, so we can get on selling new airplanes.

Btu tax. Obviously, any increase in operating costs is not welcomed by us or our customers. Our calculations show that if the tax is applied according to the published formula, 7 or 8 cents would be added to a gallon of aviation fuel. This could equate to as much as $100-million-a-year burden on the general aviation users.

However, if you do a Btu tax, our concern is that it be applied uniformly, and we ask the Congress to ensure that general aviation users do not bear more than their fair share.

General aviation is currently paying a Federal fuel tax of 15 cents per gallon for aviation gasoline and 17½ cents for jet fuel, plus taxes at the State and local level. If you do this, we would also urge that this also be acknowledged in our contribution to running the airport airway system and be part of our contribution to the trust fund.

Aircraft registration fee. The proposal to enact an annual Federal aircraft registration fee of $270 is punitive and unfair. As it is unrelated to the use of the airport airway system, it is simply a property tax on aircraft owners which is already applied by the State governments and is a major source of funding for those governments. A combined registration fee and Btu tax would certainly be an onerous burden. The registration fee is a bad idea and should be forgotten.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

Statement of
Edward W. Stimpson
President
General Aviation Manufacturers Association
on the Administration's
Proposals for Economic Stimulus and Deficit Reduction
Before
Committee on Ways and Means
United States House of Representatives
March 31, 1993

Mr. Chairman. Thank you for the opportunity to appear before this committee. I am Edward W. Stimpson, President, General Aviation Manufacturers Association (GAMA). Our association represents United States companies that manufacturer business, commuter, and personal aircraft, engines, avionics, and component parts. The aircraft our companies manufacture have 19 or less seats. They are an important part of our national air transportation system, carrying over 120 million passengers per year.

Status of the Industry

In terms of airplanes produced, 1992 was the industry's worst year since World War II — only 899 aircraft were delivered. This is in contrast to nearly 18,000 airplanes which were shipped in the late 1970s. Industry billings for 1992 were down seven percent from 1991 levels and shipments were down 12 percent. Clearly, our industry has never experienced economic recovery and we anticipate 1993 will be a challenging year.

In spite of a sluggish U.S. economy, our export market has remained active. In 1992, over 40 percent of the aircraft shipped were exported, and we foresee the export market as being important in the future.

Despite these difficult economic times, the U.S. general aviation industry has continued to invest in new products and new technology. Within the next five years alone, over one billion dollars will be spent on new aircraft development. However, the most important element for the health and vitality of our industry is a growing and expanding domestic and global economy.

We welcome and support President Clinton's goals to stimulate the economy and to reduce the federal deficit. Our industry is committed to cooperating with the Administration and Congress in achieving this goal.

Revitalization Program for General Aviation Industry

GAMA believes that a four-point program could reinvigorate the general aviation industry: 1) reenactment of the investment tax credit (ITC), 2) repeal of the luxury tax on airplanes, 3) product liability reform, and 4) continued improvement of the aviation infrastructure. Today, however, I will emphasize the tax issues.

Reenactment of the Investment Tax Credit

We were encouraged by President Clinton's statements about the investment tax credit being a key element of the stimulus package. However, we fear that the President's tax package, as it applies to business, will not realize the goals intended.

In light of the budget deficit, Congress must carefully balance the value of tax incentives against additional government "spending." Nevertheless, business tax increases, added to the complexities and limitations of the two investment tax credit proposals, greatly mitigate the effectiveness of the ITC as an incentive to buy a business aircraft.

Historically, the investment tax credit has stimulated growth in our industry and has been an important incentive for our customers to invest. After the ITC has been enacted (or reenacted) on average, sale of new aircraft have gone up by 30 percent the first year and 50 percent in the second year. As a result, thousands of jobs have been created. A chart showing the historic impact of the ITC is attached.

Why has the ITC been so successful in the past? We would suggest two important criteria: (1) the potential buyer must understand the ITC, and (2) the buyer must see the ITC offers significant value.

The "incremental" aspects of the proposed ITC does not meet the first criterion. It is too complex, and has too many qualifications to be easily understood by most of our customers. Even for those who may choose to use the incremental ITC, it's real economic value is only about one and one half percent, rather than seven percent. Thus, it is difficult for customers who could qualify for the ITC to see any significant value.

On the other hand, the proposed small business ITC could provide a more meaningful benefit because it is simpler to understand and has a greater economic value.

We urge this committee to improve the Administration proposal and make both ITC proposals simpler and of greater economic value. This will make them more effective sales tool and economic stimulus along the lines of former ten percent ITCs.

Luxury Tax

Although the luxury tax was not included in the Administration's proposal, we are heartened by statements that the President supports repeal. We urge you to use the language included in H.R. 11 last year. As you know, this repeal language was passed by the Congress twice last year and was vetoed each time for reasons unrelated to its merits.

The luxury tax has depressed sales of new business aircraft, as it has sales of other types of equipment. Instead of buying new aircraft, customers have bought used aircraft. There are certain provisions in the luxury tax which limit its impact, however, the fact is that potential customers the tax <u>may</u> apply, and they do not want to keep the additional records necessary to prove the tax <u>does not</u> apply. Businesses that otherwise would be our customers can simply buy used aircraft and avoid the luxury tax. As a result, millions of dollars of new aircraft sales have been lost.

The tax revenues generated by this tax are small compared to the negative impact of lost sales and jobs. In calendar year 1991, this tax brought in merely $119,000. For the first three quarters of 1992, only $139,000 was raised.

We are losing potential sales every week. It would be very helpful if Congress would assure our customers that repeal of the luxury tax will be effective on January 1, 1993.

BTU Tax

Obviously, any increase in operating costs is not welcomed by us or our customers. Our calculations show that if the tax is applied according to the published formula, seven or eight cents per gallon would be added to the price of aviation fuel. This could equate to as much as a $100 million dollar per year burden on general aviation users.

Our primary concern is that the BTU tax should apply uniformly to all types of transportation. We ask the Congress to ensure general aviation users do not bear more than their "fair share". In other words, the tax should be based on actual BTU consumption of each transportation mode. Price elasticity should not be allowed to transfer tax payment to other modes.

General aviation is currently paying a federal fuel tax of 15 cents per gallon for aviation gasoline and 17½ cents for jet fuel, plus state and local taxes and fees. Federal taxes go to the Airport/Airway Trust Fund. We recommend that the proceeds from this new BTU tax be placed in the Airport/Airway Trust Fund, and that general aviation users be given credit for this contribution as part of our financing the airport/airway system.

Aircraft Registration Fee

The proposal to enact an annual federal aircraft registration fee of $270 is punitive and unfair. As it is unrelated to use of the airport and airway system, it is simply a property tax on aircraft owners which is already applied by many state governments. A combined registration fee and BTU tax would certainly be an onerous burden. The registration fee is a bad idea that should be forgotten.

Summary

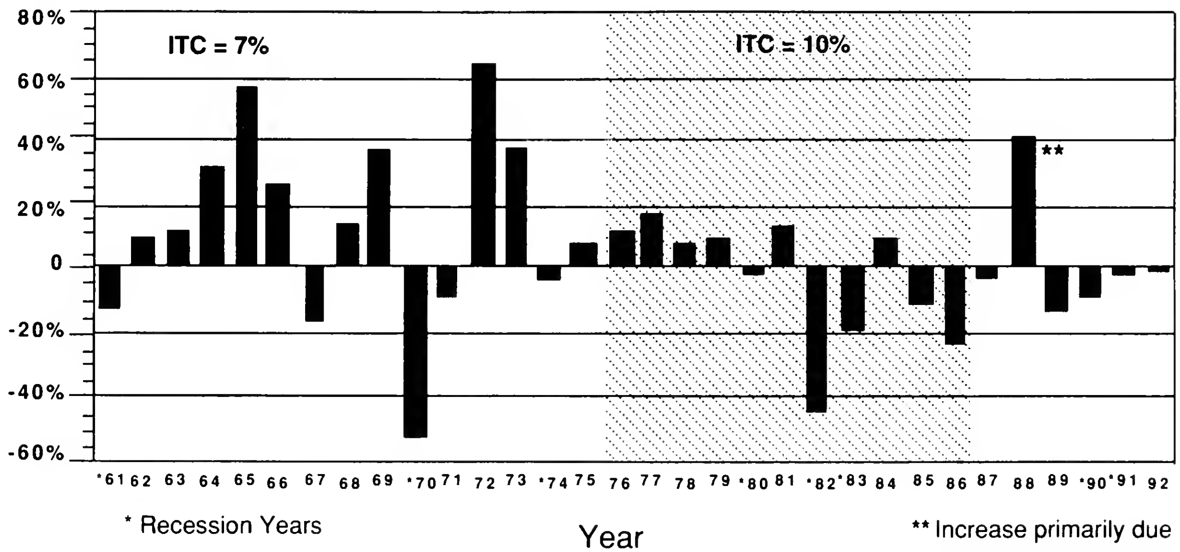
We urge the committee to:

1. Restructure the ITC to make it less complex and of more economic value in stimulating aircraft sales and the economy.
2. Repeal the Luxury Tax on airplanes.
3. If a BTU tax is enacted, ensure that it falls uniformly on all types of transportation.
4. Reject the new federal aircraft registration fee.

Thank you for the opportunity to testify. I will be pleased to answer any questions.

The Effect of the Investment Tax Credit On Domestic General Aviation Billings

Annual Percentage of Change (In 1982 Dollars)



* Recession Years

** Increase primarily due to ITC Transition Rule

Mr. HOAGLAND [presiding]. Thank you, Mr. Stimpson.
Mr. Mann.

STATEMENT OF MARK MANN, PARTNER, FRIEDMAN, EISENSTEIN, RAEMER & SCHWARTZ, CHICAGO, IL

Mr. MANN. Thank you, Mr. Chairman and members of this committee, for the opportunity to appear before this committee to respectfully share a few of the ideas that we as accountants and business advisers believe are critical for your committee to consider before completing your work on President Clinton's proposal.

My name is Mark Mann. I am the partner in charge of the tax division of the public accounting and consulting firm of Friedman, Eisenstein, Raemer & Schwartz. We are the 20th largest public accounting firm in the United States. Our entire client base consists of closely held small businesses, businesses that this committee is actively trying to support.

Census data indicate that there are over 3.7 million businesses which employ 50 or fewer employees, accounting for 30 million jobs and over $6 trillion of revenue annually.

We have come today to point out an inadvertent proposal in the tax bill that, if not modified, we believe will harm the Nation's attempt to rebuild the economy. There is an inequity at the present time in the tax proposal which will place small business at a competitive disadvantage in relationship to C corporations. Small businesses or closely held businesses will be subject to a significant tax rate increase under the President's proposal.

These businesses generally operate as S corporations or partnerships, which are conduit entities for tax purposes with the taxation of business profits occurring at the individual level. Specifically, under the current proposal, a C corporation can have taxable income of up to $10 million, and its tax rate will remain at 34 percent. However, if the taxable income of an S corporation shareholder or a partnership's partner exceeds $250,000, they will be subject to a 39.6 percent tax rate, which represents a 27-percent increase over the 1992 rates and a 16-percent higher tax rate for these businesses when compared to C corporations.

Now, we prepared for the committee's viewing pleasure a little chart here which helps demonstrate this in somewhat graphic terms. I hope you can see this. The column on the left represents the taxable income that a C corporation could have while still staying in the 34-percent bracket. The column we have here represents the taxable income that an S corporation or a partnership has before it gets to 39.6. It is roughly a ratio of 40 to 1. I thought a little visual might help, and we have some with the handout.

By placing the C corporations and the partnerships at a competitive disadvantage, you will force business ownership to either raise prices which will, in turn, prove inflationary, or for those companies that cannot or choose not to raise their prices, it will significantly increase their cost of operations, resulting in less capital invested, less jobs, less innovation, and less expansion. We fear that this provision will result in fewer closely held businesses.

Our primary recommendation is that the taxable income of the S corporations and the partnerships in which a shareholder materi-

ally participates not be subject to the 34 percent tax on taxable income below $10 million.

However, in the interest of fairness, an opposite argument that must be considered is that shareholders of S corporations and partnerships enjoy the elimination of double taxation that is incurred by C corporations. On this issue alone, taxpayers may still prefer to be an S corporation or a partnership rather than a C corporation.

Therefore, we have come today with a suggestion. As an alternative solution and in light of the double tax issue, you could provide that, where shareholders and partners retain profits and reinvest them in the business, they will defer tax.

In summary, we are recommending no tax differential between C corporations, S corporations, and partnerships or, as an alternative, have income earned by a material participant in an S corporation or a partnership taxed currently at 34 percent to the extent that the shareholders reinvest those profits by not taking distributions, provide that the additional 5.6 percent tax would be deferred until such time as those distributions are taken. This would provide a stimulus for businesses to reinvest in America. It will produce substantial new revenues and create more growth.

I would like to thank the committee for allowing us the time to highlight a few provisions in the tax proposals. We all recognize that this Tax Act will significantly impact the economy of the United States in the years to come. If we can be of any additional assistance, please feel free to call upon us at any time.

Thank you.

[The prepared statement follows:]

March 31, 1993

U.S. House of Representatives
Committee on Ways and Means
ATTN: The Honorable Daniel Rostenkowski

Dear Chairman Rostenkowski and Members of the Committee:

Thank you for the opportunity to appear before this Committee to respectfully share a few of the ideas we as accountants and business advisors believe are critical for your Committee to consider before completing your work on President Clinton's tax proposals.

First allow me introduce myself. My name is Mark Mann. I am a Certified Public Accountant, a member of the American Institute of Certified Public Accountants and the Illinois CPA Society. I have been serving the tax and business needs of closely held businesses for the past 19 years. I am the partner in charge of the tax division of the public accounting and consulting firm of Friedman, Eisenstein, Raemer & Schwartz. We are the twentieth largest public accounting firm in the United States. Our entire client base consists of closely held businesses, businesses that this Committee is actively trying to support and help grow. Businesses which fuel the economy of the United States. Census data indicates that over 3.7 million businesses employ 50 or fewer employees, accounting for 30 million jobs and over 6 trillion dollars in revenue annually.

Our country is at a point in its history similar to that experienced after World War II, a post-war economy, converting from a wartime to a peacetime economy. The end of World War II was dramatic and marked by parades and thousands of returning GI's. Today, the end of the Cold War was not marked by any single event. Our government's policies during the Cold War have led to the virtual dissolution of the Soviet Union. With the loss of this formidable adversary, certain industries are dramatically impacted. President Clinton is leading the nation towards a goal to retool our workforce, helping laid off workers rejoin that workforce and we support the President's and Congress' efforts.

Our purpose today is to comment on the President's tax proposals. We have not come to comment on the issue of the need for raising taxes. We have come to point out that, inadvertently, some of the proposed tax adjustments, if not modified, will have the result of harming the nation's attempt to rebuild the economy. In the interest of time, we have focused our comments today on a few significant issues. I am reminded of the quote from Winston Churchill "Short words are best and old short words are best of all."

Closely held businesses have always provided the majority of jobs and growth in this country. However, there is an inequity in the tax proposal which will place closely held businesses (Subchapter S Corporations and Partnerships) at a competitive disadvantage in relation to C Corporations. Closely held businesses will be subject to a significant tax rate increase under the President's proposal. These businesses generally operate as S Corporations or Partnerships which are conduit entities for tax purposes with the taxation of business profits occurring at the individual level. Specifically, under the current proposal, a C Corporation can have taxable income up to $10,000,000 and its tax rate will remain at 34 percent. However, if the taxable income of a Subchapter S Corporation's Shareholder or Partnership's Partner exceeds $250,000 they will be subject to a marginal tax rate of 39.6 percent (36 percent tax base plus 10 percent surtax) which represents a 27 percent increase over existing 1992 rates and a 16 percent higher tax rate for these businesses when compared to C Corporations. This is directly contrary to the President's and Congress' attempt to stimulate growth in small business. Businesses that fuel our economy.

The original intent of Congress, in part, when enacting Subchapter S into the Internal Revenue Code (1958) was to provide closely held business owners the limited liability protection of operating in corporate form without subjecting the shareholders to an additional level of taxation. Numerous Tax Acts have provided significant incentives that have increased the number of businesses that operate as S Corporations. Unfortunately, the proposals under consideration by this Committee increase the tax burden on owners of closely held business unfairly.

By placing the S Corporations and Partnerships at an unfair competitive disadvantage you will force business ownership to either raise prices, which will in turn be inflationary, or for those companies that cannot or choose not to raise their prices, it will significantly increase their cost of operations resulting in less capital to reinvest in jobs, innovation and expansion. We fear that this provision will result in fewer closely held businesses. This will lead to an overall reduction in tax revenues for the government whereas, by eliminating this inequity, pursuant to our recommendation, tax revenues should actually be increased.

Therefore, our primary recommendation is that the taxable income of S Corporations or Partnerships in which a shareholder or partner materially participates not be subject to a tax rate in excess of 34 percent on taxable income below $10,000,000. This would have the effect of putting S Corporations and Partnerships in parity with C Corporations.

In the interest of fairness, an opposite argument that must be considered is that shareholders of S Corporations and Partnerships enjoy the elimination of double tax that C Corporations are burdened with. On this issue alone, some taxpayers will still prefer to be an S Corporation or Partnership rather than a C Corporation. However, the surtax on S Corporation Shareholders or Partnership Partners where these businesses retain profits and reinvest in growth is inequitable. Therefore, as an alternative solution and, in light of the double tax issue, you could provide that where shareholders and partners retain profits and reinvest them into the business, they will defer tax.

In summary, we are recommending no differential in tax rates between C Corporations, S Corporations and Partnerships or, as an alternative, have income earned by a material participant in a Subchapter S Corporation or Partnership taxed currently at 34 percent to the extent that shareholders reinvest the profits by not taking distributions. The additional 5.6% tax would be deferred until such time as those distributions are taken. This provides a stimulus for businesses to reinvest in America. It will produce substantial new revenues by creating more jobs and growth.

Another provision that puts small businesses at a disadvantage concerns the eventual sale of Subchapter S Corporation stock. As presently proposed, an individual who invests the same amount of dollars into two identical businesses with the only difference being the way they are organized, one being a Subchapter S Corporation the other being a C Corporation produces significantly different tax results. The sale of stock of the Subchapter S Corporation by the Shareholder will be taxed at 28 percent. However, sale of stock by a small business (as defined by the President's proposal) C Corporation Shareholder held for at least 5 years will be taxed at a 14 percent rate. This has the potential of creating a disequilibrium of investment in C Corporations over S Corporations. We recommend that this 14% rate also be extended to S Corporation Shareholders.

I would like to thank the Committee for allowing us the time to highlight a few of the provisions in the tax proposal. As we all recognize, this tax proposal will significantly impact the economy of the United States for many years to come. This is especially true due to the fragile nature of our economic recovery. If we can be of any additional assistance, please feel free to call upon us at any time.

Mr. HOAGLAND. Thank you, Mr. Mann.
Mr. Brandt.

STATEMENT OF HELMUT BRANDT, PRESIDENT, LUNT MANUFACTURING CO., INC., SCHAUMBURG, IL

Mr. BRANDT. Mr. Chairman, my name is Helmut Brandt, and I am the president and owner of Lunt Manufacturing. We are the only exclusive magnesium die caster in the United States. We are serving the automotive, power tool, and electronic industries. I am appearing here today to explain the impact on assisting small businesses, like Lunt Manufacturing, and also the impact of locating a new large manufacturing operation in a small town and the positive economic effects.

I am here to strongly urge this committee and the Congress to provide a long-term extension of the small issue industrial development bond program that will allow Lunt and other companies to proceed with their projects. Specific to Lunt and maybe others, the extension must be made retroactive to include all projects induced prior to the June 30, 1992 expiration date. Lunt, and maybe others, need also a waiver of the IRS Code section 1.103–8(a)(5)(v)a, which requires bonds be issued within 1 year after the property was placed into service. We are running quickly out of time, gentlemen.

The company was started 20 years ago by myself. Sales in 1973 were $22,000. Today, we are in excess of $20 million. We expanded from 2,500 square feet to 85,000 square feet, from 1 employee to 175, from 1 to 13 die cast machines, from 400- to 1,200-ton capacity. We have presently the largest magnesium die cast machines in the United States and are producing the largest casting in the United States, as heavily advertised in television and newspapers with the new General Motors and Northstar engine by Cadillac. We are one of the leading magnesium die casters in the world because of our technical achievements and knowhow. This is an American dream.

The magnesium industry will double in size in the next 3 years because it will be used by the automotive industry for the Government-required CAFE standards, and magnesium is the lightest structural metal by weight.

Presently, the United States leads the magnesium industry in the world. Let's keep it and not lose it, like so many other industries.

Our biggest competitor is in Canada with a driving force to capture as much as possible of the automotive market. The Japanese have bought a domestic die casting facility to gain knowledge and expand on that market. Lunt must and wants to grow to stay on the leading edge. In Schaumburg and Elgin, IL, we are landlocked. We have no alternative and must seek another manufacturing site at the cost of $6 million.

Since it became known that we want to expand, we have been approached by foreign governments to relocate. It is known they have great incentive packages for manufacturing. The small-issue development bond program is a great substitute to combat the luring of manufacturing out of this country because not only jobs are saved and created, but also other incentives go along, for instance, reduced electrical demand rates, et cetera.

We would create 70 new jobs, approximately 250 construction jobs.

Mr. HOAGLAND. Mr. Brandt, may I interrupt a moment? We are in a vote right now. What I would like to do is recess the committee for about 5 minutes.

Mr. BRANDT. OK.

Mr. HOAGLAND. Either Mr. Brewster or I will call the committee to order just as soon as we can.

Mr. BRANDT. OK.

Mr. HOAGLAND. Thank you, and we will give you a couple of additional minutes in compensation for this. Thank you.

Mr. BRANDT. OK.

Mr. HOAGLAND. So the committee stands in recess.

[Recess.]

Mr. BREWSTER [presiding]. Mr. Hoagland will be back from voting in just a moment. I believe he said Mr. Brandt was in the middle of his testimony.

Mr. BRANDT. Yes.

Mr. BREWSTER. We need to move through our panels pretty quickly this afternoon. That is the reason we are trying to go ahead and get it reconvened.

Go ahead, Mr. Brandt.

Mr. BRANDT. Thank you very much.

As I explained before, the magnesium industry would double in size in the next 3 years because it will be used by the automobile industry for the Government-required CAFE standards, and magnesium is the lightest structural metal by weight.

Presently, the United States is the leading magnesium industry in the world. Let's keep it and not lose it, like so many other industries.

Our biggest competitor is in Canada with the driving force to capture as much as possible of the automobile market. The Japanese have bought a domestic die casting facility to gain knowledge and expand on that market. Lunt must and wants to grow to stay on the leading edge.

In Schaumburg and Elgin, IL., we are landlocked. We have no alternative, we must seek another manufacturing site at the cost of $6 million.

Since it became known that we want to expand, we have been approached by foreign governments to relocate. It is known they have great incentive packages for manufacturing. The small-issue development bond program is a great substitute to combat the luring of manufacturing out of this country because not only jobs are saved and created, but also other incentives go along, like, for instance, reduced electrical demand rates.

We will create 70-plus new jobs, approximately 250 construction jobs, and don't forget the other 12 Illinois companies which are in a standstill like us. Who knows how many others are in America.

Our site selection is Hampshire in Illinois with a population of approximately 1,800 people and a 30-minute drive from our headquarters in Schaumburg, IL. Hampshire needs a manufacturer like us to attract other businesses, and every job we create will support another 3.2 jobs in the community.

Mr. Chairman, I urge this committee and the Congress to expedite and recommend a long-term extension of the small-issue industrial development bond program and make it retroactive. This would allow my company and so many others in a similar situation for job creation and commitment to American manufacturing.

I hope that I do not have to make a decision like so many others and relocate out of this country. These are goals we all share.

Thank you.

[The prepared statement follows:]

STATEMENT OF HELMUT BRANDT
ON BEHALF OF
LUNT MANUFACTURING COMPANY, INC.
AND THE VILLAGE OF HAMPSHIRE, (KANE COUNTY), ILLINOIS
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
MARCH 31, 1993

Mr. Chairman, my name is Helmut Brandt, and I am the President and majority owner of Lunt Manufacturing Company, Inc. We are the only exclusive manufacturer of magnesium die cast parts in the United States. We primarily serve the automotive, electronics and power tool industries. Currently, the Company employs 175 people and operates from manufacturing locations in both Schaumburg and Elgin, Illinois--within the Chicago metropolitan area.

Today, I am appearing before you to explain the impact on an existing small business, Lunt Manufacturing Company, Inc., that results from our inability to undertake an expansion and modernization project due to the lack of access to small-issue industrial development bonds. I am also here to present the impact of locating a new major manufacturing operation in a relatively small community and the resulting positive economic effects. Most importantly, I am here to strongly urge that the Congress provide a long-term extension of the small issue industrial development bond program including provisions that will allow Lunt and other employers in similar circumstances to proceed with their projects. Specific to Lunt, the extension must be made retroactive to include all projects induced prior to the June 30, 1992 expiration. Lunt also needs a waiver of Internal Revenue Code Section 1.103-8 (a) (5) (v) a which requires bonds be issued within one year after the property was placed into service or was acquired (whichever occurs last).

COMPANY HISTORY

Lunt Manufacturing was started 20 years ago by myself, Helmut Brandt. The Company was created to produce high quality magnesium castings with on-time deliveries. That motto is still in existence today, although the Company is no longer a single handed operation. We have shown consistent growth in annual sales from $22,000 initially to over $20 million in fiscal year 1992. Our employment has increased from 1 to 175; and, our manufacturing space has increased from 2,500 square feet to 85,000 square feet in seven buildings. We have grown from 1 die cast machine to 13 machines that range from 400 to 1200 ton (the largest magnesium die cast machine in the United States).

Lunt has always been a "front runner" in the magnesium industry. Pioneer technology has been achieved in close tolerance, zero draft, pressure tightness, thin wall design and complexity. The Company has achieved a reputation "If Lunt can't do it, it cannot be done". Our customers are some of America's finest manufacturers including: Chrysler Corporation, Ford, General Motors, Homelite Division of Textron, Inc., IBM Corporation, Paslode Division of Illinois Tool Works, Motorola and Stanley Bostitch. We currently produce more than 200 different magnesium parts ranging from a fraction of an ounce up to 6.5 pounds (the largest magnesium casting produced in North America). By expanding our capabilities we have been able to meet the latest market developments, fulfill customer requirements, and supply quality finished parts and sub-assemblies.

The International Magnesium Association issued a "Special Award" to Lunt in 1985, a "Grand Award" in 1988 and, in 1992, a "Special Applications Award" for outstanding achievements in the magnesium die casting industry. We have received these awards in addition to numerous trade and customer quality awards that have been received over the years. It is because of our reputation to produce world class components, on a timely basis, that Lunt is considered to be one of the leading manufacturers of magnesium die cast parts.

The magnesium die cast industry is expected to double in size during the next three years. The primary growth is in the automotive sector. Government standards for corporate average fuel efficiency (CAFE) and pollution control legislation are forcing auto makers toward the production of lighter, more fuel efficient motor vehicles. Magnesium is the lightest of all structural metals and benefits from the ease at which it can be cast into complicated shapes thereby eliminating costly machining.

Currently, the United States is leading the world in the development and use of magnesium. However, Japan and Canada are rapidly gaining a foothold into the market. Lunt's primary competitor is a Canadian venture that is continually striving to increase its stake in the automotive industry. According to 1991 industry data, they had 43 percent of the market share based on weight of pounds shipped. The Japanese recently acquired a domestic magnesium die-caster, and they, based on the same data, had approximately 26 percent of the market based on weight of pounds shipped. Lunt, at the time the data was collected, had 13 percent of the market. Today, however, our production has increased significantly and we are nearly even in market share. What is important about this information is that as the leading domestic magnesium die-caster, we are being aggressively challenged by the Canadian and Japanese. Lunt must continue its growth if we are to remain competitive. Our intent is to continue, if not accelerate, our growth and we need our new manufacturing facility, financed through the IDBs, if we are to accomplish this goal.

This brief historical perspective presents the background which led us to the decision that it was necessary to permanently expand the Company's manufacturing capacity. Inasmuch as Lunt is landlocked in its Schaumburg location(s), we have no recourse but to seek alternative manufacturing sites. Company representatives initiated a site and financing search in late 1991 and early 1992. Although geographic preference initially focused on nearby labor market areas, it was, of necessity, expanded to include economically competitive locales. Since the time of our decision to expand, we have been "courted" by multiple municipalities, several states, the Government of Quebec, Canada and have had initial discussions with German officials.

Concurrent with its site selection process, Lunt was also working with financial advisors to secure the most favorable financing for its anticipated $6 million expansion. Based on advice and guidance from recognized financial experts, the Company concluded that small-issue development bonds were the <u>most</u> effective means of financing the project. In February, 1992, Lunt began working with the Illinois Development Finance Authority (IDFA) in order to pursue this form of financing. The IDFA is a multi-purpose financing agency for the State of Illinois and the principal issuers of qualified small-issue industrial development bonds in the State. Inasmuch as a final site decision had not been reached, and because we anticipated multiple locations for equipment placement and because of their expertise and demonstrated successes, Lunt chose to work through the IDFA rather than a specific unit of local government.

In March, 1992, the IDFA approved the Company's initial request of $6 million in Industrial Development Bond financing. The project would result in the creation of at least 70 new manufacturing jobs within two years after completion; would create 200-250 construction jobs during the nine month construction period; would permit an existing Illinois company to expand its presence within the state; and, would result in a significant investment and commitment to the economy.

As the Company pursued its financing arrangements, it also narrowed its site selection options. In early Spring, 1992 it entered into a contingent option to purchase a 14 acre industrial site in the Village of Hampshire, Illinois. The Village, with a population of 1,843, is strategically located in Kane County (within the six county Chicago metropolitan area). It is within 3 miles of the Interstate 90 and U.S. 20 interchange and approximately 39 miles from O'Hare International Airport. Although technically and statistically within the larger metropolitan area, Hampshire reflects the rural characteristics of a small community.

Recognizing all of the assets that the Village had, it still took an aggressive marketing approach on the part of the Village representatives to secure our contingent commitment. It was through local efforts that the Company identified its site of choice and through the Village that economical ways of financing necessary infrastructure costs were determined. Village officials agreed to request, on our behalf, grant assistance through the State of Illinois Department of Commerce and Community Affairs, funds necessary for access roads, relocation of existing sewer lines and provision of adequate water sources to service our sprinkler system. The Village's efforts combined local and state resources and their commitment has continued, over these many months, to insure our location in Hampshire.

It is through this proactive business development that the Village has realized several new business operations in their boundaries, including a new floor and ceiling truss manufacturing operation which employs nearly 50 people; a privately financed manufacturing incubator building which houses four operations; and, a start-up business that designs and manufacturers hybrid electronic modules that is expected to employ 50 individuals within the next 12 months. In addition to these successes, the Village is nearing completion on an ambitious annexation program that will bring the geography at the I-90 and U.S. 20 interchange into the corporate limits.

A major part of their development efforts have been Hampshire's work with Lunt Manufacturing Company. As previously stated, the Village has worked with the Company in identifying sites, providing liaison with engineers and utility companies and in identifying a trained labor pool. Furthermore, the Village has worked with the Illinois Development Finance Authority and Congressional Offices in pursuit of permanent financing for the proposed expansion.

Now, however, both the Village and Lunt are at a standstill. On June 30, 1992 the bill allowing industrial development bonds expired. Original plans called for Lunt to be in its new facility by January, 1993. It is now three months beyond that deadline and we are no further than we were over a year ago. Lunt has lost major accounts due to its inability to identify a new location and increase its manufacturing capability. It has been seriously pursued by other locales to open a new manufacturing operation and no new jobs nor investment have occurred within the Village as a result of its efforts.

<u>An extension of the small issue bond program, made retroactive to include those projects initially induced prior to the June 30, 1992 expiration is necessary</u> if the Lunt Manufacturing Project is to proceed. IDBs provide access to capital markets generally open only to major corporations. If our issue had closed before August, 1992, the bonds would have been placed through Merrill Lynch in New York as part of a tax exempt pooled bond fund. This would have given Lunt the ability to use "public generated capital" while maintaining its sovereignty as a privately held corporation.

IDBs allow a lower interest inasmuch as the rates paid are tax exempt to the bondholders. The rates are, typically, 2 percent less under IDBs as compared with conventional financing. Specifically, this would have amounted to a $120,000 annual savings for Lunt or a total benefit valued at $1.2 million.

IDBs financing lends itself to a longer debt payment structure for the project. Generally, terms for conventional financing range between 5 to 7 years while the structure negotiated for Lunt reflected a 12 year, fixed rate, with the principal remarketed after the twelfth year. This type of structure and extended term are very important to capital intensive, growth oriented manufacturing companies like Lunt.

Addressing interest rate sensitivity through IDB financing is much more favorable than through conventional methods. Through the IDB vehicle, Lunt had been able to fix the interest rate for a longer period, 12 years, which would have been impossible under conventional terms. In addition, we had also succeeded in securing a two year principal payment deferral, with a 20 year amortization. This kind of beneficial structure would not have been possible <u>but for</u> IDBs.

Also important to note, is the applicability of other programs if the project is financed through industrial development bonds. In our case, this is particularly relevant because of the Rider 19C provisions through Commonwealth Edison. Our utility savings under Rider 19C, over a five year period are estimated at $300,000. Without the IDB financing, we are not eligible, according to Commonwealth Edison, for this benefit.

A long term extension of this program is necessary if companies like Lunt and municipalities like Hampshire are to realize increased economic viability, expansion of the local tax base and job creation and retention opportunities. An extension of this program has been argued by the National Governor's Association, along with the National League of Cities, the National Association of Counties and Council of Industrial Development Bond Issuers, among others. The small manufacturing companies can wait no longer for this much needed financing vehicle.

In testimony presented before this Committee on April 10, 1991, Ronald Bean, Executive Director of the Illinois Development Finance Authority, stated that

> "Small issue bonds, which are now carefully targeted to smaller manufacturers, provide a critical source of the financing necessary for these businesses to establish new plants or modernize existing facilities. In areas hard hit by the so-called 'credit crunch', they may indeed be the only source of financing or the only resource for affordable financing. For many companies, the bonds are a key component of their strategies to combat heavily subsidized foreign competition since they are the only form of federal assistance to help smaller manufacturers."

I am in complete accord with Mr. Bean's statement. According to recommendations prepared by the Council of Development Finance Agencies, presented to then President-elect Clinton on December 18, 1992, "...states and local economic development agencies have been unable to encourage local economic growth by providing access to capital at affordable rates through these tax-exempt bonds." Lunt is one of those businesses that has been unable to expand, maintain a competitive edge in its industry and access new accounts because of the expiration of this financing tool.

According to data provided by the Illinois Development Finance Authority,

> "...most of the heavy losses (in Illinois) have occurred in the state's manufacturing centers; during the past year, the state has lost 17,000 factory jobs, according to the Illinois Department of Employment Security. Because IDBs are targeted solely to manufacturing and because most IDBS are used to expand or modernize an existing facility, these projects enable us to hold onto precious manufacturing jobs. The manufacturing job-loss statistics are distressing but without IDBs the losses would no doubt be even larger."

In the years 1987-1992, Illinois, through the IDFA, has been involved in 107 Small Issue Industrial Development Bond projects, representing a volume of $482 million. These projects have resulted in the creation of 4,322 new jobs and the retention of 10,045 jobs. These numbers cannot be ignored. Currently, IDFA has 12 projects with induced IDBs representing a significant number of investment dollars and approximately 1000 new jobs for Illinois.

It has been clearly demonstrated that small-issue IDBs provide a critical source of financing necessary for small businesses. Small manufacturing firms--those with assets of less than $25 million-represent a significant force in the U.S. economy. In 1990, approximately one-fifth of all manufacturing was produced by these firms. An analysis developed by Professor James A. Heins at the University of Illinois, Bureau of Business Research, demonstrates that each manufacturing job in Illinois provides income and economic power to support 3.2 additional jobs in other businesses from banking to fast-food restaurants. We need these jobs--not only in Hampshire, not only in Illinois but in the United States.

The delay in my ability to expand my facility has caused other comparisons to be made. At the current time, I am in contact with representatives from the Government of Quebec, Canada regarding a Canadian location for my manufacturing plant. They have represented some attractive opportunities and, unfortunately, they cannot be ignored. The governments of many countries provide significant subsidies to reduce the cost of capital for their corporate borrowers. In Germany--another area interested in our expansion--the government offers financial assistance in the form of subsidies or loans. Government assistance is for the establishment of businesses; expansion, modernization and relocation of businesses; and, for the innovation and introduction of technology.

<u>In our country, IDBs offer one of the few federal incentives to smaller U.S. companies to help them reduce their capital costs.</u> Small issue industrial development bonds, through favorable rates and terms, and in simply helping to provide available capital, provide financing that is indispensable to the growth of the nation's manufacturing sector.

Mr. Chairman, I urge this Committee and the Congress to expeditiously enact the recommendation to provide a long-term extension of the small-issue industrial development bond program. This would allow my Company, and so many others in similar situations, to realize our expansion and modernization efforts, job creation and commitment to American manufacturing. These are goals that we all share.

Mr. BREWSTER. Thank you, Mr. Brandt.

The next person is Mr. Chapler with the Iowa Finance Authority.

STATEMENT OF TED R. CHAPLER, EXECUTIVE DIRECTOR, IOWA FINANCE AUTHORITY

Mr. CHAPLER. Thank you.

My name is Ted Chapler. I am the executive director of the Iowa Finance Authority, which is the primary issuer of all tax-exempt debt in the State of Iowa. I would like to thank the committee, and especially Representative Grandy, for the opportunity to speak here today.

I was originally going to focus on the IDB's and also the agricultural bonds. But, as I took a look at the entire area, it was hard for me to really separate those out from also the mortgage revenue bonds and the low-income housing tax credit, because how we approach development of all sorts in our State is as a package.

For instance, we commonly make many trips around the State to small towns, large towns. We try to present them with an array of what we can do, both industrial development financing, agricultural financing, as well as housing. These are all interconnected in that, especially with IDB's; any manufacturer looking to expand or relocate also wants to know that there is adequate housing at a price level affordable for their potential new workers. If any one of these tools are gone, then we are missing part of the equation.

Where agricultural bonds fit in all of this, again, is population stability. Farmers in Iowa and nationwide, they skewed very old. The average farmer is over 55 years old, and they are not being replaced with their younger counterparts, as in other segments of society. Agricultural development bonds, really, are the only tool for these young farmers to have an access to cheap-enough capital for the immense start-up cost of farming, land, equipment, livestock, whatever it may be.

With the average farmer being over 55, we look at the demographics of the agricultural program, of our agricultural bond program. Over 90 percent of our applicants are under 35 years old. So we are really replacing the older generation of a farmer, which is on its way out, with the younger generation.

With agricultural bonds expiring every year and every year expiring sometimes in June, sometimes in September, sometimes in December, it is hard for them to have any confidence that they can do any long-range planning for themselves, and so sometimes they may be forced into some financing prior and before they are really ready or, if they do wait, they may not get that opportunity.

Ag bonds have been gone for almost a year now, at the authority, we have received over $18 million in applications from young farmers, and we have to tell them, "We will keep your applications on hold, but right now there is no program." We have to have this tool, IDB's, everything back in order to continue with an orderly planning process not only for ourselves, but also for the affected individuals and businesses out there.

The reason we urge that these programs be renewed not only for just a year, but permanently is they have a proven track record of working. In Iowa, it is primarily a rural State, and we were devastated by the farm crisis in the early eighties. We have built our

way back from that by trying to diversify our economy. We have issued over $400 million in small-issue IDB's, and we issued over $100 million in beginning farm bonds.

I believe our ag bond program is the second largest or first largest in the country, depending on how you look at it, and our IDB program has helped stabilize and bring a lot of manufacturing activity to rural and urban Iowa.

All this has helped eradicate or lessen Iowa's dependence solely on the aging farmer. These programs have worked well for us and I believe they have worked well for the country in helping us be competitive overseas in both grain and in manufacturing, and I don't like to isolate any one component, IDB's, ag bond, housing, because if we are doing our job right, we are representing a package to sort of take care of a whole societal problem, a whole economic problem in an area because of our sort of—this is sort of a cliche—our holistic approach to all of this.

We would urge that they all be extended and permanently, so we can do some long-range planning because that is equally frustrating for us in that we have to package deals together probably prematurely or maybe not quite as thought out as they could be just to meet the various deadlines because they are on a constant, variable, expiring schedule.

I guess, in summary, I would argue that—I would urge that they all be extended, regardless of any negative revenue hit that can be calculated, and I don't think this has been calculated, because all of these also bring a lot of construction activity, a lot of increased tax base, and a lot of population stability, and I am not sure those tax gains or revenue gains are necessarily calculated against the offsets.

Thank you very much.

[The prepared statement follows:]

WRITTEN STATEMENT OF

TED R. CHAPLER, EXECUTIVE DIRECTOR
IOWA FINANCE AUTHORITY
100 EAST GRAND AVENUE, SUITE 250
DES MOINES, IOWA 50309

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
MARCH 31, 1993

My name is Ted Chapler. I am Executive Director of the Iowa Finance Authority which is the primary issuer of tax-exempt financing in the state of Iowa.

I would like to thank Chairman Rostenkowski, Representative Fred Grandy, and the other members of this Committee for the opportunity to offer my thoughts regarding the need to provide for the permanent extension of small issue industrial development bonds, agriculture bonds, mortgage revenue bonds, mortgage credit certificates and low income housing tax credits.

Permanent extensions of each of these programs is essential to the economic recovery of this country and certainly for the state I come from located in the heartland of America. The nation's economy is experiencing a serious and prolonged economic slump, and a significant focus of this session of Congress will be working with the President to obtain an economic stimulus package that will lift our economic well being. I encourage you to pursue those efforts to invigorate our economy.

However, in your efforts to pass new legislation to provide for that economic stimulus, I caution you not to forget about existing programs that provide an economic lifeline to many throughout our country. Indeed, each of the programs that I urge you to permanently extend are already on the books and have a proven track record of providing significant economic support to our communities and our states. Any economic stimulus package adopted by Congress should include a permanent extension of each of these programs.

In Iowa we suffered through an extended economic downturn when the rest of the country was booming in the 1980's. We were hit hard by the depression that rocked agriculture. We painfully learned the need to diversify our economy. Since the mid-80's, our state has embarked on a consistent and steady course to accomplish that diversification.

As a result, Iowa's economy is growing and our problems are not as severe as in some parts of the country.

The reason is quite simple: we have marshalled the resources of our state government and the authority that is granted to us by the federal government to assist the private sector in creating a stable economic base. We certainly have not yet achieved all of our goals for economic growth, but we are making progress, strong steady progress.

Each of these programs -- industrial development bonds, agriculture bonds, mortgage revenue bonds, mortgage credit certificates and low income housing tax credits -- have all played a critical role in Iowa's economic diversification strategy. However, our efforts to develop a long-term economic strategy with each of these programs has been hampered by the annual fear of their extinction. We learned in Iowa that we need long-term planning, long-term investments and long-term commitments if we are to achieve real and lasting economic growth.

As a result, it is essential that Congress provide long-term extensions for each of these programs so we can count on them to help reinvigorate our economy.

Why are each of these programs so important? They are important because they work. Unlike the proposals that you have for new programs and new ideas, each of these programs has a proven track record that includes the necessary ingredients for economic success.

Consider, for example: First, each of these programs is designed to maximize the leverage of private investment capital in important and varied projects. Government, considering its fiscal constraints, certainly cannot do it all. It cannot create lasting economic growth independently. Instead, the government can provide the necessary economic incentives to encourage private investors to place their capital on the line to bring about economic growth. Each of these programs does just that.

Second, each of these programs is cost-effective. The incentives that the federal government provide are returned many times over in new investments, new jobs and economic activity that is returned to the communities and to the states.

Third, each of these programs creates jobs. In many respects, the current crisis in consumer confidence rests on the deep seated concerns of many Americans as to whether or not they are going to have a job in the future. A permanent extension of each of these programs will relieve the fears of many Iowans and many Americans that those jobs will not be there in the future.

Fourth, each of these programs deals with significant social needs in our country: access to capital for small businesses, incentives for the family farmer, low income housing assistance and help for first-time homebuyers. Each of these important and necessary social goals are addressed by the incentives provided in these federal programs. In essence, with the permanent extension of these programs, you would be generating significant economic activity <u>and</u> meeting real social needs simultaneously.

Finally, these programs are flexible. They allow the states to fit them within their existing array of economic incentives and economic development initiatives to maximize the ability of states to achieve real economic growth. As such, each of these programs is an essential part of Iowa's economic development agenda.

Let me illustrate this point by describing for you how we have used each of these programs.

<u>SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS.</u> Since 1982, the Iowa Finance Authority has issued more than $580 million in tax-exempt financing for more than 300 business development projects under the small issue industrial development bond program. These IDBs are a vital link in Iowa's public policy of economic diversification and job creation. In many cases, this program provides the essential needed capital for a small business to expand and create quality jobs.

<u>AGRICULTURE DEVELOPMENT BONDS.</u> Since its inception in 1981, over $100 million in loans have been provided to young farmers to get them started in farming. These bonds provide an affordable means for beginning farmers to acquire their first piece of land or gain ownership of productive assets. Iowa is at risk of losing an entire generation of farmers if we do not make certain that our young aspiring farmers have access to reasonably priced capital. The average farmer is over 55 years old, while over 90% of the participants in this program are under 35 years old. This program provides a way in which we can leverage private money from Iowa banks to provide the necessary start-up financing needed by many young farmers. Since this program expired last year, over $18 million in loan requests have been received. This program is an essential part of our effort to save the family farm.

<u>SINGLE FAMILY MORTGAGE LOAN PROGRAM.</u> Through the sale of tax-exempt revenue bonds, the Iowa Finance Authority provides financing for low interest mortgage loans throughout the state. Mortgage loans are for either new or existing homes. The purpose of the program is to provide adequate and affordable housing for low and moderate income families. What have we accomplished? Since the Authority was established in 1975, we have helped over 23,000 low and moderate income Iowa families acquire their first home. A recent housing study we have conducted in Iowa shows that over 100,000 low income Iowa families are still in need of housing assistance. We need to continue this program so we can make the American dream come true for those families as well. From an economic standpoint, this program has been a striking success. We have financed over $1 billion in low-interest home loans for these first-time homebuyers in our state.

MORTGAGE CREDIT CERTIFICATES. Iowa was the second state in the nation to offer the mortgage credit certificate program. This program assists in making home ownership more affordable to low and moderate income first-time homebuyers. To date the Authority has issued more than 6,600 mortgage credit certificates totalling over $277 million to eligible first-time homebuyers. That means a home has been provided for 6,600 families who would not otherwise have been able to own their own home. Clearly the mortgage credit certificate program is filling an important niche in the Iowa home ownership market.

LOW INCOME HOUSING TAX CREDIT PROGRAM. The low income housing tax credit program has been a tremendous success in Iowa. The Authority has allocated $13.9 million in tax credits to 220 multi-family low income housing projects. We have leveraged over $222 million in private development for over 6,300 affordable housing units through the use of this program.

SUMMARY

To summarize, we have needs in the heartland of America. We have the need to diversify our economy. We have housing needs for the many rural poor who live in substandard housing. We have a need to provide capital to agriculture so that America's future farmers can get their start. We have a need to provide reasonably priced apartments for elderly and single-parent families. We have a need to provide assistance to first-time homebuyers so they can realize the American dream.

Congress has acted wisely in the past by extending each of these programs dealing with these significant social and economic issues. But, as I have indicated, we have to go through a period of uncertainty at the end of every year, waiting to see whether or not those programs are going to be extended. We absolutely must have these programs extended on a permanent basis if we are to provide a true economic recovery for America.

Permanent extensions are needed if we are to provide the necessary incentives to developers to do the planning required to make these projects a reality. We need permanent extensions if we are to obtain the necessary equity financing that allows each of these programs to maximize their financial leverage. We need permanent extensions if we are to truly deal with the significant social and economic needs of Iowans and Americans today.

Iowa is coming back, and America can come back as well. We have found in Iowa that we can restore economic health only by developing strong and enduring partnerships between business and government to encourage economic growth. We need the same partnerships at the national level. All of these programs encourage and assist in developing those partnerships. Now it is up to you to make certain that these partnerships will be enduring to let us achieve our full potential.

Thank you for your consideration.

Mr. HOAGLAND [presiding]. Thank you, gentlemen.

Let me ask each of you questions, and if I could ask you to keep your responses brief, I will try to keep my questions brief.

First, Mr. Stimpson, I see in your statement here some comments critical of the temporary investment tax credit. The Joint Tax Committee tells us that the temporary part of the tax credit in the President's proposal would cost about $12 billion during the 2-year lifespan of the proposal and whatever credits are claimed thereafter.

I would like your opinion as to whether it is worth that expenditure, regardless of how the money might otherwise be used; in other words, is it worth $12 billion to the economy.

Mr. STIMPSON. Well, I would just speak from the standpoint of our business. If you want to put people back to work and create jobs, and it does, it works, ITC has worked, as you see from this chart that I showed you, when it goes up 30 percent the first year, industry buildings have increased 50 percent the second year.

I would say if it is a jobs deal in a place like Wichita, KS, where we produce a lot of airplanes today, and 8,000 people will be laid off there at Boeing very shortly, the ITC would help sell airplanes. It would put some of those people back to work. I think yes would be my answer.

Mr. HOAGLAND. But you are critical of what is the temporary nature of it?

Mr. STIMPSON. No, I was more critical of the incremental nature, rather than the temporary nature. We obviously like a long term. If I had my choice, yes, I would like 10 percent forever here. But a temporary thing, I would rather have a temporary one than none, and my main criticism was directed, I think, to the incremental nature of which you have to go over all of these hurdles before you can use it, and it has really deluded the impact of it considerably. So you really don't have a 7 percent ITC, but 1½ or 2 percent.

That is the nature of my criticism, not the temporary versus the permanent as much.

Mr. HOAGLAND. Let me ask you a question, Mr. Mann. In your statement, you criticized the proposed increase in tax rates on S corporation income earned by high-income individuals, and you recommend that we cap such income at 34 percent. Now, would that have the effect of treating S corporations more favorably than an equivalent amount of wage income?

Mr. MANN. I am not sure I understand your question.

Mr. HOAGLAND. Would the net effect of that be to treat S corporations more favorably than wage income coming from other sources?

Mr. MANN. Do you mean from C——

Mr. HOAGLAND. Partnerships or individuals, right.

Mr. MANN. What we tried to do in our presentation is talk about an alternative to allow S corporations to reinvest those proceeds. Our alternative solution is not just to level it off at 34 percent, but to provide a 5.6-percent increase, unless those people reinvest the proceeds back into their businesses.

I am not sure I am answering your question.

Mr. HOAGLAND. No, I think that is fine.

Mr. MANN. OK.

Mr. HOAGLAND. That is fine.

Mr. Belcaster, you have indicated you favor extending the 2.5-cents-per-gallon tax beyond 1995. Would you favor an even sharper increase in the gas tax if the revenues were used to fund mass transit or other similar programs?

Mr. BELCASTER. Mr. Chairman, I would strongly endorse such a move because, since 1990, different issues have been brought to bear on public transit. One is the American with Disabilities Act, which we still do not know what the real costs of that are going to be.

In Chicago, we know, for example, that they are 2½ times what they originally estimated it to be, and that puts us in the $400 million range just for one city and one transit agency. So I suspect our experience will be similar around the country.

In addition to that, the Clean Air Act mandates us to change our bus engines, in short order, and begin work on alternate technologies for fuel and for engines, and in addition to that, corporations are forced into a trip reduction act. All of this has occurred since 1990, and the effects of that and the cost to the industry are going to be staggering.

I think what we are arguing, or in answer to your question, yes, it would be excellent to increase beyond even the 2½ cents.

Mr. HOAGLAND. Thank you.

Mr. Brandt, maybe you could explain to us the secret of your success.

Mr. BRANDT. Well, like I said, that is an American dream, and I emigrated to this country in 1961. I started 7 years later my business as a tool-maker, and 5 years later, I had an opportunity to go into die casting. And magnesium is a rare commodity which not too many people know of. So I have been very successful and have been working and expanding it even.

Last year, I added 50 employees, which many other companies couldn't do, and I invested $2.8 million with the hope that this small-issue industrial development bond will be extended. So, therefore, I am asking that it will be made retroactive to whatever has been induced prior to June 30, 1992. I need it, and I think many, many other companies are in the same boat.

Mr. HOAGLAND. You have been remarkably successful, and your advice is well taken.

Did you emigrate from Germany?

Mr. BRANDT. Yes, I am from Germany. Yes.

Mr. HOAGLAND. You weren't a rocket scientist when you were in Germany, were you?

Mr. BRANDT. Pardon me?

Mr. HOAGLAND. You weren't a rocket scientist in Germany, were you?

Mr. BRANDT. A rocket scientist?

Mr. HOAGLAND. A rocket scientist. People say you need to be a rocket scientist——

Mr. BRANDT. No, no, no.

Mr. HOAGLAND. Never mind. [Laughter.]

Mr. Chapler, is that the way you pronounce your name?

Mr. CHAPLER. Yes.

Mr. HOAGLAND. I want to welcome you to the committee as a fellow Midwesterner.

Do you have any revenue estimates on what it would cost to make these extenders permanent that you suggest or any thoughts as to where the revenue might come from?

Mr. CHAPLER. Well, I know how they are evaluated down here that it is always revenue-negative, but, then you start backing it up and think a lot of this requires a lot of additional construction, it creates the job, increases the tax base, which doesn't necessarily help the Federal Government, but it certainly helps us.

I don't know how you can calculate all of the tax benefits or the revenue-positive benefits of all these things, but I am not sure that those are offset against the negative. So maybe the picture looks worse than it actually is.

Also, there is something to be said that these bring stability to various areas, both in housing, farming, and manufacturing.

Mr. HOAGLAND. Thank you.

Let me recognize Mr. Hancock for 5 minutes.

Mr. HANCOCK. Thank you very much, Mr. Chairman. I have a series of questions. I will ask them as quickly as possible.

Mr. Stimpson, as part of the aircraft manufacturing association, if you were to make a choice between the changes going on right now of not getting the ITC, keeping the luxury tax in effect, supporting the Btu, and accepting the aircraft registration or the product liability change, which one would your industry favor, do you think?

Mr. STIMPSON. Boy, that is a tough question. But I think if I was a small aircraft manufacturer making piston airplanes and had a long history, a long fleet out there, I would take product liability. I would take product liability reform because it would start my piston engine line again.

For example, Cessna has not made a piston airplane since 1986 because of product liability. They said if there is reform, they will start again.

I think, in the long term, it is an uncontrollable thing to tax things you can over time make change, live with the product liability in general aviation. It is absolutely out of control at this point in time, and that is why I think I would favor that.

Mr. HANCOCK. Thank you, sir.

Mr. Brandt, I was interested in your comments that the chairman made about your being successful in your company. You started 20 years ago. What would be the situation in today's age with all of the new regulations and all of the stuff that we have loaded on the small businessman over the past 20 years if you were to start your company now? Could that happen? Do you think that you could start a company now? Now, think back to the things that you didn't have to do 20 years ago that now you would be required to do. How much capital did you invest 20 years ago to start your company, and, to do the same thing now, what would you have to have?

Mr. BRANDT. Well, 20 years ago, it was much, much easier, I have to admit that. I think if you want to start an operation or a die casting like mine today, even the 400-ton machine runs a $250,000 investment, and that is just the main machine. You need

the furnaces, trim presses, and other support equipment. So I think I had it at that time relatively easy, and for somebody—he has to have a lot of money behind him before he can start this kind of business. Twenty years ago startup cost was $75,000.

Mr. HANCOCK. How many people do you think that you would have to hire now just to advise you on how to comply before you ever even talked about buying equipment to comply with all of the OSHA regulations, all of these things, before you could even start thinking about starting a business like yours?

Mr. BRANDT. I started as a one-man operation, and, of course, as the growth has taken on, I put more people to work and gave them responsibilities, and one thing especially I would like to point out is the environmental issues. We are all in compliance, but we are bombarded constantly with more forms and more regulations to be filled out and complied to, and that would add more people to my operation.

As newcomer starting out in business, either you have to work more hours, which I have been doing all my life—I am not an 8-hour person. Twelve and fourteen hours is normal with me, and I think it is quite tough to do it at all as one person. You need, right away, a few more.

Mr. HANCOCK. You are considering now the possibilities—and you don't want to do it, but you have been offered incentives to go overseas?

Mr. BRANDT. yes.

Mr. HANCOCK. If you were starting now, would you start it in the United States or would you go overseas?

Mr. BRANDT. You shouldn't forget there are great incentives if it is in Canada or in Europe.

Mr. HANCOCK. Fine. Thank you, sir.

Mr. BRANDT. You know, there are great incentives there, and that makes it a little easier for a person to start there.

Mr. HANCOCK. Thank you, sir. I appreciate that.

Mr. Mann, were you here earlier this morning when I was asking the questions about your position paper?

Mr. MANN. I heard part. I came in just at the tail end of your discussion.

Mr. HANCOCK. I got to thinking about this over the past 2 to 3 weeks because I happen to have a small business, a subchapter S small business. We invested money last year subject to hiring more employees this year. If the current tax goes through as written in subchapter S, then we are not going to be able to hire those employees even though we had already made the investment last year.

Do you find several of your clients in that position?

Mr. MANN. Yes; we do. We find that people right now are very much concerned about this raise; that they feel it is not fair that subchapter S corporations are being singled out and partnerships; and that the ratio, this disparity, a 40-to-1 ratio is simply not equitable. It violates the basic premise of trying to spread the tax fairly.

Mr. HANCOCK. I am asking for an opinion here. I mean, I realize you haven't conducted any polls. But does this appear to you to be part of the ongoing effort to tax the rich?

Mr. MANN. Well, it seems to me that it is an inadvertent error in the overall philosophy of taxing the rich because people don't realize that the people that they are going to be taxing are not wealthy and that it is going to be putting these businesses at a competitive disadvantage. But, yes; it is under the guise of taxing the rich.

But what we were trying to point is that, inadvertently, that is not what is happening and that we would like to see a change, so as to protect the small business owner.

Mr. HANCOCK. This tax then is actually going to end up taxing the small business owner. Whereas, that is the economic engine that is going to create the jobs.

Mr. MANN. Correct.

Mr. HANCOCK. One final question, Mr. Chairman.

You mentioned that they should be taxed at 34 percent. Does this mean you support the corporate tax increase from 31 to 34? And if your proposal says that it is good to hold it at 34, why wouldn't it even be better to hold it at 31?

Mr. MANN. To answer your question, no, we are not supporting an increase from 31 to 34.

In putting together our paper and our position, we were trying to be very practical and offer some alternatives to this committee and not just come and complain about increases in rates. Chuck Baron, who is my partner, and myself, when we were putting together the paper, we just decided to hold it at 34, but we very much would rather hold it at 31. But we just decided that we were going to try to offer the committee a compromise position, rather than trying to be arbitrary and just take a radical position. So we thought that this would at least bring some parity and some equality between the rates, and so it was just we just figured it out for ourselves.

Mr. HANCOCK. I will ask one final question. I said final last time, but it didn't work out that way.

From the small business standpoint that has been profitable—let's say one guy owns the whole thing or maybe a father and son or what have you—if the individual tax goes through the way it is, wouldn't the incentive be to take all of the money out that he possibly can out of his own company? If, in fact, he is fairly well-financed, would there not be an incentive to borrow money within that company to get his earnings out of there, and invest that money in tax-frees and in other potential capital-gains-producing investments like the stock market or something that he would maybe get taxed at the 28 percent tax rate? Would the incentive be to take money out of his company and invest it someplace else?

Mr. MANN. It is difficult to give an answer for everybody in the United States, but I think there——

Mr. HANCOCK. I mean, if he is a fairly well-financed company.

Mr. MANN. Yes, I think there is certainly incentive to do that. I think, more importantly, there is no incentive for him to leave his money in. That I could agree with wholeheartedly. There is no one who would want to do it.

And the other problem is that people will start converting out of sub S's and go into another form of operation which was unintended, and that is also a concern. So people will discover that this

problem is there. They will shift, and the revenue source won't be there for the Federal Government, anyway.

Mr. HANCOCK. Thank you.

Mr. HOAGLAND. The time of the gentleman has expired.

Mr. Crane, I recognize you for 5 minutes.

Mr. CRANE. Thank you, Mr. Chairman, and I want to congratulate all of the witnesses, but I have to single Helmut Brandt because he has a business that is just beyond the line from my district, but most of his employees are from my district. They live in the township of Schaumberg, and we have Hanover, also, very close by. [Laughter.]

My area was originally settled by German farmers, Helmut. So that is kin throughout the area.

I want to also comment, if it hasn't been stressed, on the facility that Helmut developed. To me, this is a classical American success story. He came to the country as an immigrant and started a business up from scratch, and he has that exclusive distinction of being the only manufacturer of magnesium die casting, as I think I am quoting correctly, in the entire Nation.

Mr. BRANDT. That is correct.

Mr. CRANE. Something you indicated with that long-term IDB extension is that, if you could get $6 million in IDB financing, the project would create 70 manufacturing jobs and 250 construction jobs. And I was trying to do some quick calculations. That works out to about $20,000 per job, does it not?

Mr. BRANDT. Yes.

Mr. CRANE. The reason I focus on that is the President's stimulus package breaks down to about a $90,000 cost to create a temporary job this year as the stimulus to the economy, and, gee, you know, that would create 3½ jobs in the private sector if we could figure out how to provide these kinds of extensions and incentives, and those are enduring jobs. His $16 billion stimulus package is a temporary program, and, as I say, it is to create, in effect, make-work. Presumably that is going to help the economy, although it is aggravating the deficit, and I don't quite understand all of this new economics.

But the fact of the matter is I wholeheartedly endorse that extension, and it is based upon your own experience with IDB's. I am sure everyone else has probably had, at one time or another, some comparable experience. So I am not here, really, to interrogate you. I know what your options are. I don't want to see you leave our neighborhood. Those jobs are important to us back home, but I think they are important to us as a Nation, too. I simply congratulate you.

Again, I want to express appreciation to all of the witnesses for their testimony.

Thank you.

Mr. BRANDT. Thank you.

Mr. HOAGLAND. Thank you, Mr. Crane, and my thanks to the panel for having taken the time to travel and present us with your thoughtful testimony. Gentlemen, thank you very much, and your statements will be submitted for the record.

I call our next panel, which consists of Richard Holder, Brett Wilcox, R. Emmett Boyle, James S. Frank, and Donald L. Correll.

Gentlemen, welcome to the committee. Thank you for your willingness to participate, particularly as the final panel of the day.

Beginning with Mr. Holder, perhaps each of you could begin your testimony.

Could we have some order, please, in the committee room.

Perhaps each of you, beginning with Mr. Holder—and I don't know if you have been notified of the order of your appearance—followed by Mr. Wilcox, Mr. Boyle, Mr. Frank, and Mr. Correll, could begin by giving us your name and the organization that you are associated with and your title with that organization.

Mr. Holder, you may begin. Thank you for coming.

STATEMENT OF RICHARD G. HOLDER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, REYNOLDS METALS CO., RICHMOND, VA, AND CHAIRMAN, THE U.S. ALUMINUM ASSOCIATION

Mr. HOLDER. Thank you, Mr. Chairman and members of the committee.

I am Richard Holder, chairman and chief executive officer of Reynolds Co. I also serve as chairman of our trade group, the U.S. Aluminum Association, which represents 80 member companies with a total of 134,000 employees and more than $4 billion in payrolls.

To save time, I have submitted written testimony on the technical details of primary aluminum production and believe that that will also be addressed by others.

I do want to stress one point in my personal testimony today. Aluminum is as much a feedstock as any other raw material used in the primary aluminum production. Electricity's role in aluminum production is clearly a nonfuel use.

The proposed Btu tax will have a major impact on the global competitiveness of the U.S. industry if electricity used in the primary aluminum production process is not recognized as a nonfuel use. The total cost to the aluminum industry of the Btu tax would be $289 million. Even with the nonfuel classification, our industry would pay $117 million in new energy taxes.

Our industry suffered the worst year in its history in 1992, which included the loss of several thousand jobs. With the end of the cold war, the Commonwealth of Independent States quadrupled aluminum exports to the west to more than 1 million tons to raise hard currency. International producers added another 1 million tons of new primary aluminum capacity, and competition from Government-subsidized overseas plants continues to increase. Competitive pressures on the aluminum industry in the United States is enormous, and there are no signs that that is going to lessen.

These exports from offshore countries and other recessionary pressures have resulted in a decline in the primary aluminum price to a current 52 cents per pound on a worldwide market basis. Now, this is an historic low for the price of aluminum ingot on an inflation-adjusted basis. This price compares to an average industry production cost of about 60 cents per pound according to industry analysts.

Prior testimony to the committee estimated that the Btu tax for primary production would add only 3 percent to the cost of a pound of aluminum. The 3 percent equates to approximately 2 cents per

pound at current prices, which is, indeed, substantial for an industry where one-quarter of a cent per pound in the price can mean the difference in obtaining an order. Our calculations, in fact, estimate that this tax would increase primary aluminum production cost by 2.4 cents per pound, which is more than a 4-percent increase.

This tax increase would only compound the pressure caused by impending double-digit increases in energy rates for the 40 percent of the U.S. capacity located in the Pacific Northwest and the added cost of compliance with the Clean Air Act of 1990, as well as other regulatory pressures.

The EEC has recognized the importance of the survival of the European aluminum producers by the decision of its nations' primary aluminum producers or the decision that its nations' primary aluminum producers would receive exemptions from the proposed energy tax.

The U.S. industry already has done an outstanding job in energy conservation. By investing in technology since 1972, the primary aluminum industry has reduced the Btu's needed to make a pound of aluminum by 22 percent. In addition, by recycling 63 billion aluminum cans in 1992, or 68 percent of all of the aluminum beverage cans made in the United States in that year, we have saved substantial amounts of energy by using more and more recycled aluminum.

If competitiveness of the U.S. industry continues to be weakened, we run the risk of repeating a history which saw American aluminum producers close substantial primary capacity in the 1980's. My company, Reynolds Metals Co., closed four of its seven primary aluminum plants because of higher energy costs which made them noncompetitive with foreign producers.

The Reynolds plants that closed were the economic backbone of their communities. The former plants in Arkadelphia and Malvern, AR; Sheffield, AL; and Corpus Christi, TX, employed 5,200 people who earned more than $166 million per year.

In each of these plant communities, we paid tens of millions of dollars for supplies and State and local taxes that supported school systems and government services. Our workers purchased cars, appliances, homes, and other products in the local economy.

Our former employees were dedicated and productive. Mr. Chairman, I can never forget the agony that we felt in our company when the 5,200 long-time fellow employees were told that their plants would be permanently closed.

This is certainly history that we do not have to repeat. Good industry jobs numbering 24,000 with good wages would be jeopardized and put under additional cost pressures in 10 States represented by committee members if electricity is not considered as a nonfuel use in aluminum production at the 23 surviving smelters in the United States.

For these plants, their employees, and their communities, a feedstock, nonfuel use classification for the primary aluminum production process is crucial to survival.

Thank you very much.

[The prepared statement and attachments follow:]

STATEMENT OF THE ALUMINUM ASSOCIATION, INC.
CONCERNING THE IMPACT OF PRESIDENT CLINTON'S ENERGY TAX PROPOSAL
ON THE U.S. ALUMINUM INDUSTRY

Summary of The Aluminum Association's Energy Tax Position

The U.S. aluminum industry supports President Clinton's efforts to reduce the federal deficit. One aspect of the President's plan calls for the enactment of a British thermal unit (Btu) tax on energy. It also provides that non-fuel uses of energy will not be taxed.

Electricity used in the process of smelting primary aluminum, as well as petroleum and coal derivatives in carbon anodes and cathodes are non-fuel uses that should not be subject to the President's Btu tax proposal. There are no substitutes for these non-fuel uses.

The Btu tax attributable to non-fuel uses in primary aluminum production would be about $172 million. Recognition of the non-fuel use character of the electricity and carbon used in producing primary aluminum would still require the U.S. aluminum industry to contribute over $117 million to the federal treasury in Btu taxes.

Primary aluminum is an international commodity whose price is set on the London Metal Exchange (LME) and other major world exchanges. The increased costs of production resulting from the Btu tax cannot be passed on to customers, especially when the world price is at or below the cost of production.

Low energy cost countries like Canada, Australia, Brazil, Venezuela, Norway and the Middle East are both traditional and growing suppliers of primary aluminum. Many of those countries would be very supportive of a U.S. Btu tax because they would benefit by taxation that makes the U.S. industry less competitive. The C.I.S., particularly Russia, is a huge supplier to world markets now that the former Soviet domestic economy has not found new domestic uses for metal once used primarily by the military.

The Btu tax will severely disadvantage and jeopardize the U.S. primary aluminum industry both in the U.S. and export markets.

The U.S. aluminum industry requests that the Btu tax mechanism enacted by the Congress recognize that non-fuel uses (electricity and carbon anodes and cathodes) in the production of primary aluminum should not be covered by any such plan.

The U.S. aluminum industry supports the Administration's proposal that the Btu tax not apply to the exports of aluminum in all forms to avoid harming the industry's ability to remain competitive in world markets.

The President's Energy Tax Proposal

The President's energy tax proposal would impose an excise tax on fossil fuels (coal, oil, natural gas) at a basic rate of 25.7 cents per million Btu, with an additional tax on oil of 34.2 cents per million Btu. A tax would also be imposed on hydro and nuclear-generated electricity "at a rate equal to the national average" of the tax on electricity from fossil fuels.

The <u>tax</u> would be:

- o $5.57 per ton of coal;
- o $3.47 per barrel of oil;
- o $ .26 per 1000 cubic feet of natural gas; and
- o $ .27 per hundred KwH of hydro and nuclear-generated electricity.

In addition to its primary purpose of <u>raising revenue</u>, the tax has three purposes:

- o reducing environmental damage;
- o fostering energy conservation; and
- o reducing dependence on foreign sources of energy.

While the tax is described as an energy use tax, it would also provide for exemptions and downstream credits for non-fuel use and exports.

<u>The Aluminum Reduction Process</u>

<u>The three key feedstocks in the chemistry of the process by which aluminum metal is produced are: anode carbon, alumina, and electricity</u>. The electrolytic process is the only commercially proven method of producing the metal.

Aluminum does not occur in nature as metal, but rather as its oxide, alumina (Al_2O_3). Deposits of bauxite ore are mined and refined into alumina -- one of the feedstocks for aluminum metal.

Alumina and electricity (the second feedstock) are combined in a cell with a molten electrolyte called cryolite.

Direct current electricity is passed from a consumable, carbon anode into the cryolite, splitting the aluminum oxide into molten aluminum metal and oxygen. The molten aluminum collects at the bottom of the cell and is periodically "tapped" into a crucible and cast into ingots.

The process of splitting alumina into aluminum metal and oxygen consumes approximately 7 KwH per pound of aluminum produced. Continual progress has been made over the 100-year history of aluminum processing to reduce the electricity requirement. There are currently no viable alternatives to the process described above.

The electricity used in the process and the petroleum and coal derivatives used in carbon anodes and cathodes, by which aluminum metal is made from alumina (Al_2O_3), are non-fuel uses of energy.

<u>The Impact of the Tax to the Aluminum Industry</u>

If the Btu tax were levied on non-fuel energy uses in primary aluminum production, it would amount to production cost increases of approximately $172 million. This translates to a 2.4 cent increase in the cost of producing a pound of aluminum (4 percent cost increase).

If the tax is applied to aluminum fabrication without recognition for the non-fuel uses of electricity and carbon, the cost of producing mill products domestically would rise by about 1.7 cents per pound. If the non-fuel uses of electricity and carbon in primary metal production are properly accounted for, the U.S. industry's cost for mill product operations would increase by about one-half a cent a pound.

This would translate into an additional $117 million in revenues to the U.S. Treasury for energy used in manufacturing operations.

World Competitiveness

Beginning in 1982, U.S. aluminum companies began a process of restructuring to accommodate the competitive realities of the changing nature of the global aluminum economy. By 1992, the number of plants was reduced from 680 to 550, including the elimination of nine smelters representing one million metric tons (MMT) of production.

Primary aluminum is an international commodity whose price is set on the LME and other major world exchanges. Costs of production can not be passed on automatically to customers, especially when the world price is at or below the cost of production. According to Anthony Bird, a leading world aluminum analyst, the average cost of producing a pound of primary aluminum in the U.S. is more than 60 cents and the current LME price is in the 52-54 cents per pound range.

While the U.S. is the world's largest producer of primary metal (approximately 4 MMT), it is a net importer of ingot, primarily from Canada. Japan and the E.C. are also major importers of primary metal. Canada, Australia, Brazil, Venezuela and Norway have been the traditional suppliers of metal to the world. The C.I.S., particularly Russia, have in the past three years become a major exporter of metal. With the collapse of the Soviet economy, there are no domestic markets for the metal being produced in the C.I.S. and with a recession in the West, there has been no place for this metal. Many of these countries would be very supportive of a U.S. Btu tax on primary aluminum production because they would benefit by taxation that makes the U.S. industry less competitive.

What all of this means is that a U.S. Btu tax will severely disadvantage the U.S. primary aluminum industry in the U.S. and export markets (Japan now imports some metal from the U.S.).

It further means that U.S. mill products production would either rely on foreign metal or risk being undercut in the U.S. market and would be in certain jeopardy of losing export markets. Japan, the E.C., and Canada are our major trading partners.

Energy Conservation

From its inception, the U.S. aluminum industry has pursued the reduction of its use of electricity. Over time, the average amount of electricity needed to make a pound of aluminum has gone from more than 12 KwH in the 1940s to approximately 7 KwH today. These reductions are technologically based and are implemented with larger capital investments. Continued energy conservation has resulted in a 23 percent reduction since 1972 in the amount of energy required to make a pound of aluminum mill products.

An important contributor to making aluminum more energy efficient has been the growth of recycling. In 1972 secondary metal accounted for one MMT or 18 percent of the nation's total metal supply of 5.445 MMT. By 1991, secondary metal accounted for 2.5 MMT or 31 percent of the total of 8 MMT. The increased use of recycled metal is a trend which will continue.

The energy used to produce aluminum is saved for future re-use through recycling. Applications of aluminum in transportation and elsewhere significantly reduce energy and fuel use.

The aluminum air battery which has a replaceable aluminum anode and an air cathode with a flowing electrolyte has been researched as a power source for a battery operated vehicle.

Replacing heavier weight materials with one thousand pounds of aluminum on a mid-sized sedan results in a vehicle which is 25 percent lighter and 20 percent more fuel efficient. The vehicle would save 770 gallons of gasoline over its 100,000 miles of service and the metal would be recycled at the end of its service life.

Environment

U.S. aluminum producers and fabricators adhere to the most stringent environmental rules applicable anywhere in the world to aluminum manufacturers. Substitution of foreign aluminum ingot and mill products for U.S. products will result in a net loss of global environmental protection.

The 3.5 million tonnes of aluminum production in the C.I.S. is substantially without health, safety or environmental controls.

U.S. Competitiveness

In the markets in which primary aluminum and mill products compete, success or failure is based on fractions of a penny. If any U.S. materials industry is benefited by a credit or exemption for non-fuel use of energy, then all competing materials which are denied a non-fuel credit or exemption will be severely disadvantaged.

Aluminum competes directly in all of its major uses with other materials (steel, plastic, glass, etc.) which will also be requesting adjustments based on non-fuel use -- equity demands that all competing materials be treated equally by government action and that each be able to compete on the basis of inherent characteristics.

By the same token, to avoid penalizing U.S. manufacturers, exports of materials and products should be credited with tax paid on fuels used in production. Export credits must continue to be part of the President's proposal if the U.S. aluminum industry is to avoid international competitive jeopardy by reason of a U.S. Btu tax.

Conclusion

The U.S. aluminum industry supports the President's efforts to reduce the deficit, and to foster energy conservation, an improved environment and less reliance on foreign sources of energy.

The industry requests that the electricity, petroleum and coal derivatives which are essential feedstocks in producing aluminum from alumina be properly designated as non-fuel uses of energy.

Further, we support the Administration's proposal for energy credits for all aluminum exports.

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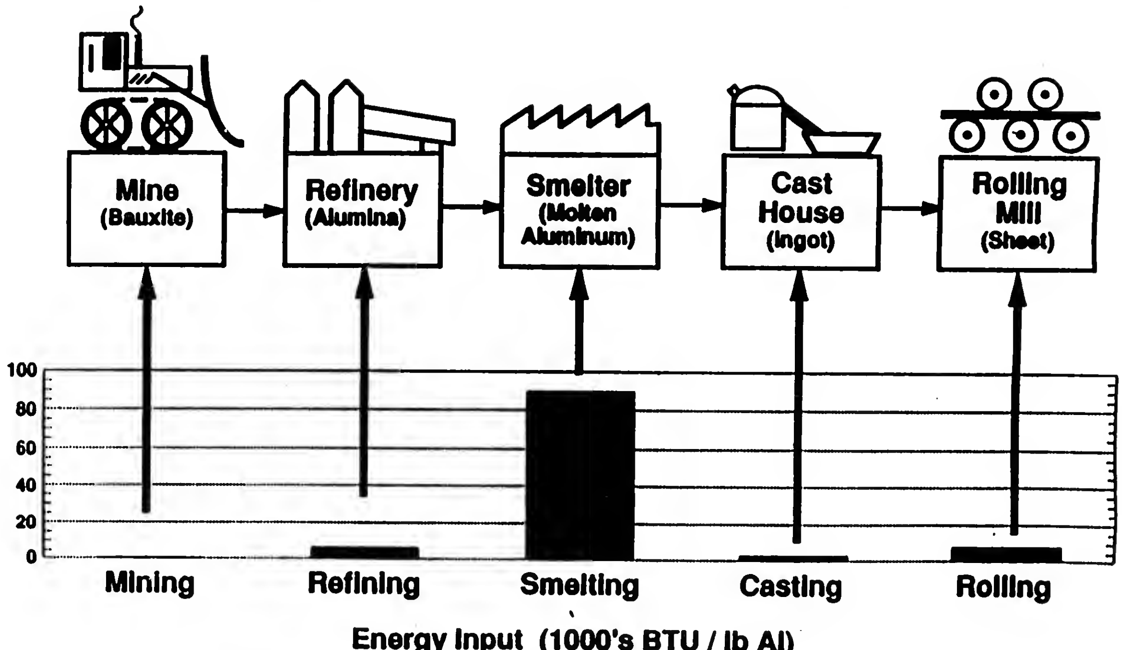
Estimated Effect of BTU Tax
On the U.S. Aluminum Industry

	Billion BTUs	Estimated Tax $000	Estimated Tax With Credit $000
Alumina (Bauxite Refining)			
Fossil Fuels	47,250.5	12,202.8	12,202.8
Electricity	10,105.3	2,597.0	2,597.0
Total	57,355.7	$14,799.8	$14,799.8
$/lb. @ 10.0 billion pounds		0.0015	0.0015
Primary Aluminum (Reduction Process)			
Fossil Fuels	83,305.9	39,220.7	14,520.2
Electricity	674,326.6	177,663.0	30,625.3
Total	757,632.5	$216,883.7	$45,145.4
$/lb. @ 8.9 billion pounds		0.0244	0.0051
Primary Aluminum (Including Alumina)			
Fossil Fuels	130,556.4	51,423.5	26,722.9
Electricity	684,431.8	180,260.1	33,222.3
Total	814,988.2	$231,683.5	$59,945.3
$/lb. @ 8.9 billion pounds		0.0261	0.0067
Aluminum Mill Products			
Fossil Fuels	120,183.2	32,773.7	32,773.7
Electricity	90,138.6	24,573.2	24,573.2
Total	210,321.8	$57,346.9	$57,346.9
$/lb. @ 17.1 billion pounds		0.0033	0.0033
Total Aluminum Industry			
Fossil Fuels	250,739.6	84,197.2	59,496.6
Electricity	774,570.4	204,833.2	57,795.5
Total	1,025,310.1	$289,030.4	$117,292.1
$/lb. @ 17.1 billion pounds		0.0169	0.0068

Note: (*) Excludes energy consumed by an estimated 1,000 U.S. aluminum foundries

Source: The Aluminum Association
March 12, 1993

ENERGY REQUIREMENTS IN THE ALUMINUM INDUSTRY



From Aluminum Association Report, "Patterns of Energy and Fuel Usage in the U.S. Aluminum Industry, Full Year - 1989", Report to the Dept. of Energy, August 27, 1991.
HYDRO KWH = 10,500 BTU = FOSSIL FUEL EQUIVALENT

U.S. Aluminum Industry

Industry Profile	1990	1982	Percent Change
Employment			
All Employees			
Number (1000)	133.5	134.2	-0.5
Payroll ($MM)	4,042.7	3,223.6	25.4
Production Workers			
Number (1000)	104.6	104.0	0.5
Wages ($MM)	2,873.6	2,335.9	23.0
Value Added by Mfg ($MM)	8,938.2	5,013.9	78.3
Cost of Materials ($MM)	21,698.4	15,282.2	42.0
Value of Industry Ship. ($MM)	30,641.9	20,641.1	48.5
Quantity of Shipments (MM lbs)	17,037.0	12,115.0	40.6

Source: Annual Survey of Manufacturers, 1990, Bureau of the Census
Census of Manufacturers, 1987 & 1982, Bureau of the Census
The Aluminum Association, Inc.

U.S. Primary Aluminum Capacity

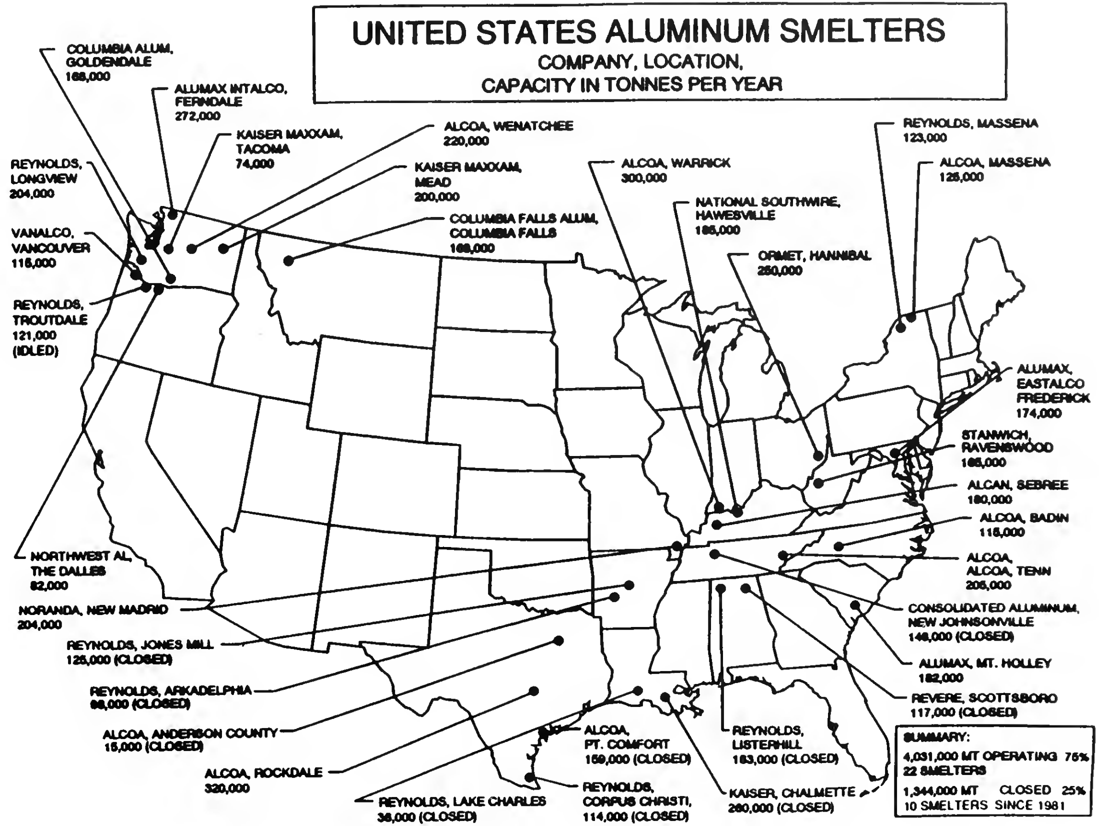
Location	Company	Capacity (Metric Tons) Rated 01/01/93	Utilized 01/31/93	Number of employees	Type of Power	Power Company
Pacific Northwest						
Wenatchee, Wash.	Alcoa	220,000	178,000	900	Hydro	Bonneville Power Administration
Ferndale, Wash	Alumax - Intalco	272,000	204,000	1,788	Hydro	Bonneville Power Administration
Goldendale, Wash.	Columbia Aluminum	168,000	126,000	1,100	Hydro	Bonneville Power Administration
Columbia Falls, Mt.	Columbia Falls	168,000	126,000	661	80% Hydro/20% Thermal	Bonneville Power Administration
Mead, Wash.	Kaiser	200,000	150,000	1,164	Hydro	Bonneville Power Administration
Tacoma, Wash.	Kaiser	74,000	56,000	370	Hydro	Bonneville Power Administration
The Dalles, Ore.	Northwest	82,000	71,000	467	Hydro	Bonneville Power Administration
Longview, Wash.	Reynolds	204,000	204,000	829	Hydro	Bonneville Power Administration
Troutdale, Ore.	Reynolds	121,000	Idled	865	Hydro	Bonneville Power Administration
Vancouver, Wash.	Vanalco	115,000	115,000	670	Hydro	Bonneville Power Administration
Total Pacific Northwest		1,624,000	1,228,000	8,808	98% Hydro/2% Coal	
Ohio Valley						
Sebree, Ky	Alcan	180,000	180,000	750	Thermal, Coal	Big River Power
New Madrid, Mo.	Noranda	215,000	215,000	1,186	Thermal, Coal	Elec Co-op of Springfield
Warrick, Ind.	Alcoa	300,000	300,000	1,800	Thermal, Coal	Southern Ind. Gas & Elec & Alcoa Generating Corp.
Hannibal, Ohio	Ormet	250,000	250,000	1,600	Thermal, Coal	Ohio Power Co.
Ravenswood, W.Va.	Ravenswood	165,000	165,000	868	Thermal, Coal	Ohio Power Co.
Hawesville, Ky.	Southwire	185,000	185,000	700	Thermal, Coal	Green River Rural Electric
Total Ohio Valley		1,295,000	1,295,000	6,883	100% Coal	
Other						
Badin, N.C.	Alcoa	115,000	115,000	950	60% Hydro/40% Thermal Coal & Nuclear	Alcoa Generating & Duke Power Co.
Alcoa, Tenn	Alcoa	205,000	205,000	1,300	20% Hydro/80% Thermal Coal	Alcoa Sub of Tapoco & TVA
Massena, N.Y.	Alcoa	125,000	125,000	1,600	50% Hydro/50% Thermal Nuclear	Power Authority of N.Y.
Rockdale, Texas	Alcoa	315,000	315,000	1,800	Thermal, Lignite	TX Power & Light/Alcoa
Frederick, Md	Alumax - Eastalco	174,000	174,000	1,142	Thermal, Coal	Potomac Edison & Allegany Power
Mount Holly, S.C.	Alumax, Inc	182,000	145,000	1,186	Thermal, Coal	South Carolina Public Service
Massena, N.Y.	Reynolds	123,000	123,000	738	90% Hydro/9% Thermal Nuclear	Power Authority of N.Y.
Total Other		1,239,000	1,202,000	8,157	69% Coal/23% Hydro/7% Nuclear	
Total U.S.		4,158,000	3,728,000	24,046	53% Coal/45% Hydro/2% Nuclear	
Percent Operating Rate			89.6%			

Source: Primary Aluminum Plants Worldwide, U.S. Bureau of Mines, 1990
Aluminum Ingot Capacity, American Metal Market, January 1993
Aluminum Association Surveys

The Aluminum Association, Inc. - March 12, 1993

UNITED STATES ALUMINUM SMELTERS

COMPANY, LOCATION,
CAPACITY IN TONNES PER YEAR



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Total Aluminum Supply
(Thousands of Metric Tons)

Year	Total Supply	Domestic Primary Production	Imports Total	Imports Primary	Imports Mill Products	Secondary Recovery
1971	5,146	3,561	582	503	78	1,004
1972	5,445	3,740	684	598	86	1,022
1973	5,759	4,109	523	461	63	1,127
1974	6,123	4,448	511	461	50	1,163
1975	5,093	3,519	453	394	59	1,121
1976	5,799	3,857	608	522	86	1,334
1977	6,256	4,117	683	608	75	1,456
1978	6,783	4,358	907	688	220	1,518
1979	6,880	4,557	711	518	193	1,612
1980	6,833	4,653	603	527	76	1,577
1981	7,061	4,489	782	645	138	1,790
1982	5,762	3,274	823	616	207	1,666
1983	6,149	3,353	1,023	743	281	1,773
1984	7,235	4,099	1,376	882	494	1,760
1985	6,594	3,500	1,332	869	463	1,762
1986	6,655	3,039	1,843	1,349	494	1,773
1987	7,035	3,347	1,702	1,246	456	1,986
1988	7,534	3,945	1,467	1,027	440	2,122
1989	7,437	4,030	1,353	926	427	2,054
1990	7,863	4,048	1,421	962	459	2,393
1991	8,020	4,121	1,398	1,029	369	2,501

Source: Bureau of the Census, U.S. Department of Commerce
Bureau of Mines, U.S. Department of Interior
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U.S. ALUMINUM INDUSTRY OVERVIEW

ALUMINUM SUPPLY AND DEMAND (millions of pounds)	% of Total	1991
Total Supply	100.0	17,681
Primary Production	51.4	9,086
Secondary Recovery	31.2	5,514
Imports of Ingot & Mill Products	17.4	3,082
Aluminum Can Reclamation		
Pounds of Aluminum Collected		1,969
Number of Cans Collected (billions)		56.8
Percent of Aluminum Cans Collected		62.4
Primary Capacity (year-end)	100.0	9,111
Pacific Northwest	39.3	3,580
Ohio Valley	31.1	2,831
Other	29.6	2,700

U.S. FOREIGN TRADE - 1991 (million of pounds)	% of Total	Total	Ingot	Scrap	Mill Products
Total Imports	100.0	3,563	2,268	481	814
Canada	81.5	2,903	2,115	357	432
European Community	5.4	191	7	22	162
Japan	2.2	80	1	*	79
Mexico	1.9	67	*	60	7
Other	9.0	321	145	41	135
Total Exports	100.0	4,053	1,754	1,023	1,275
Japan	48.5	1,967	1,352	562	53
Canada	20.3	824	136	99	589
Mexico	6.9	281	75	57	149
European Community	3.8	155	30	42	84
Other	20.4	825	162	263	400

Note: (*) Less than [illegible] thousand pounds

Source: U.S. Department of Commerce, Bureau of the Census
Foreign Trade Division

SHIPMENTS TO MAJOR MARKETS (millions of pounds)	% of Total	1991
Building & Construction	13.9	2,320
Transportation	16.5	2,764
Consumer Durables	6.2	1,041
Electrical	7.6	1,276
Machinery & Equipment	5.6	940
Containers & Packaging	29.1	4,873
Other	3.2	532
Total Domestic Shipments	82.1	13,746
Exports*	17.9	2,992
Total Net Shipments	100.0	16,738

Note: (*) Exports of aluminum ingot and mill products adjusted for discrepancies in published foreign trade statistics

Source: U.S. Department of Commerce, Bureau of the Census
Current Industry Report (M33D)
Foreign Trade Reports
U.S. Department of Interior, Bureau of Mines
Mineral Industry Surveys
The Aluminum Association, Inc.

INDUSTRY PROFILE - 1990 (millions of dollars)	Primary Metals	Aluminum	Percent Aluminum	Other Nonferrous	Steel
Employment					
Total Employees (1000)	712	134	18.8	187	391
Payroll	22,477	4,043	18.0	5,268	13,166
Production Workers (1000)	548	105	19.1	138	306
Payroll	15,933	2,874	18.0	3,356	9,704
Value of Industry Shipments	146,052	30,642	21.0	41,225	74,186
Cost of Materials	92,878	21,698	23.4	27,237	43,942
New Capital Expenditures	5,789	1,207	20.8	1,050	3,532
Energy Consumption					
Cost of Fuels & Electricity	8,247	2,269	27.5	1,116	4,863
Electricity Consumption					
Purchased					
Quantity (mil kWh)	148,798	71,838	48.3	15,141	61,819
Cost	5,110	2,063	40.4	509	2,538
Generated (mil kWh)	8,249	(na)	(na)	(na)	(na)
Cost of other purchased fuels	3,138	391	12.5	426	2,321

Note: Figures in millions of dollars unless otherwise specified
(na) Data not available

Source: U.S. Department of Commerce, Bureau of the Census
1990 Annual Survey of Manufacturers

Mr. HOAGLAND. Thank you, Mr. Holder for your testimony.
Mr. Wilcox.

STATEMENT OF BRETT WILCOX, PRESIDENT, NORTHWEST ALUMINUM CO., THE DALLES, OR

Mr. WILCOX. Thank you.

I am Brett Wilcox, president of Northwest Aluminum Co. With me are Janice Menzie and Dan Lacy, our union president and vice president.

Northwest Aluminum Co. operates a 90,000-ton-per-year aluminum smelter and a new casting and recycling facility in The Dalles, OR. Together, our two plants employ 489 people.

At the outset, I want to emphasize that we strongly endorse your efforts to reduce the Federal deficit. However, there are two areas where we believe the proposed package is not fair and would have serious adverse impacts: application of the Btu energy tax to aluminum reduction and imposition of the 10 percent surtax on S corporation income.

With respect to the Btu tax, I want to summarize three points. One, electricity and carbon used to make aluminum are nonfuel feedstock. Two, failure to apply the feedstock exemption would make the U.S. aluminum industry uncompetitive and lead to shutdowns and layoffs. Three, application of the tax won't raise significant additional revenue.

In order to understand why electricity is a feedstock, it might be helpful to explain that the aluminum is produced by passing electric current through alumina while it is dissolved in a solution of molten cryolite. Alumina consists of two atoms of aluminum that each lack 3 electrons and 3 atoms of oxygen that each have 2 excess electrons. Electricity, which simply is the flow of electrons, is necessary to supply the 3 missing electrons to the atoms and alumina to make metallic aluminum. Scientifically, electricity is a feedstock in aluminum reduction, fundamentally different than normal fuel used. In a very real sense, aluminum is nothing more than stored electricity.

Congress also should clarify that the petroleum coke and coal used to build the anode and cathode of an aluminum reduction cell represent nonfuel uses. The carbon anode attracts and stabilizes the negatively charged free oxygen atoms like a magnet. The cathodes simply holds the molten aluminum and does not supply any energy to the process.

Electricity represents approximately 50 percent of our production cost at Northwest Aluminum. The proposed Btu tax would increase our electricity rates by about 12 percent. This represents a 2.4-cent-per-pound tax on aluminum. For our company, that adds up to about $4½ million a year.

Aluminum is a worldwide commodity. The U.S aluminum industry has no ability to pass on higher costs caused by a domestic Btu tax. The energy tax would make us uncompetitive. It would force us to shut down in current aluminum markets and ultimately could drive our plant and many of the other 23 aluminum smelters remaining in the United States out of business.

Imposing the Btu tax on aluminum not only is scientifically incorrect and competitively injurious, it won't raise significant addi-

tional revenue. First, shutdown smelters don't pay the tax and stop paying existing taxes. Second, in order to give U.S. producers any chance to survive international competition, the proposal properly provides a credit for aluminum exports. However, GATT rules prohibit applying the Btu tax to aluminum imports. Since additional freight costs almost always would be less than the proposed tax, economic reality compels a producer to export production to avoid the Btu tax and import foreign aluminum.

The second issue I would like to discuss is S corporation income. Subjecting S corporation income to the 10 percent surtax is unfair and puts S corporations at a significant competitive disadvantage. The stated purpose for raising the corporate tax rate to the same 36 percent individual rate is to avoid inequities in the choice of business form, but the 10 percent surtax conflicts with this purpose and discriminates against the small businesses like us that usually choose to be S corporations.

The obvious solution is to tax S corporations at the same rate as C corporations by excluding S corporation income from the 10 percent surtax, just as you propose to exclude capital gains income. Exclusion is appropriate since S corporation income is not the sort of passive millionaire benefit from the 1980's tax structure that the surtax was intended to recapture. Instead, S corporation is just like C corporation income. It is the active work product of thousands of small businesses that generate our Nation's job growth.

While I believe the committee should adopt a general rule excluding S corporation income, you at least should provide a special exception for companies like Northwest Aluminum that have a general profit-sharing plan. Don't impose the millionaire surtax on our 489 hardworking union members and employees.

Thank you for the opportunity to present these comments.

[The prepared statement follows:]

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS & MEANS

Testimony of

Brett Wilcox, President
Northwest Aluminum Company

March 31, 1993

Good afternoon, I'm Brett Wilcox, President of Northwest Aluminum Company. With me today are Janice Menzie, President of United Steelworkers Local 9170, and Dan Lacy, union Vice President.

Northwest Aluminum Company operates a 90,000 ton per year primary aluminum smelter and a new aluminum casting and recycling facility in The Dalles, Oregon. Together, the two facilities employ 489 people.

Our aluminum smelter previously was owned by Martin Marietta Corporation, which totally shut down the plant in 1984. After over two years of effort to restructure the operation and reduce costs, we were able to acquire and reopen the smelter in 1986. We have since been operating with record efficiency and productivity under a very close and unique labor/management partnership. We have significantly expanded our value-added production and, in 1991, opened a new state-of-the-art aluminum cast house and recycling facility. We are very proud of our labor, business and environmental records.

GENERAL COMMENTS

At the outset I want to emphasize that we strongly endorse your efforts to reduce the federal deficit. In general, we think the President's proposals offer a framework to significantly improve America's competitiveness.

We realize that deficit reduction will require that our company and others make some significant sacrifices. We definitely do not complain about paying our fair share of tax increases. There are two areas, however, where we believe the proposed package is not fair and would have serious adverse impacts on our company and the nation as a whole.

The two areas I would like to address are (1) the proposed BTU energy tax as it applies to aluminum reduction and hydroelectric power, and (2) the proposed 10% surtax on high income taxpayers as it relates to S-Corporation income.

BTU ENERGY TAX

The Committee should clarify that electricity and carbon used to make aluminum are non-fuel uses exempt from the BTU energy tax. Imposition of the tax is inconsistent with the intent of the

feedstock exemption and discriminatory to the Northwest aluminum industry. The BTU tax also would make U.S. aluminum production uncompetitive in the world aluminum market and lead to the shutdown of much of this strategic industry, without raising significant additional revenue.

Impact of the BTU Tax

Electricity represents approximately 50% of our cost of producing metal at Northwest Aluminum Company. Electricity obviously is our largest single cost and the cost that determines our relative competitive position and ability to survive.

The proposed BTU tax would increase electricity rates in the Northwest by approximately 12%. This represents a 2.4 cent per pound tax on aluminum. For our company, that adds up to about $4,500,000 per year in additional costs.

The BTU tax would come on top of a 20-25% rate increase that the Bonneville Power Administration plans to impose on October 1, 1993 in order to ensure repayment of the federal investment in the Northwest power system, to cover significant additional costs to protect and restore our endangered salmon runs, and to pay the increased costs of BPA's resource and other programs. BPA faces another significant increase in two years. Taken together, the energy tax and BPA's regular rate increases could lead to a 40-50% increase in power rates to our plant and other BPA customers in the Pacific Northwest.

Aluminum is a worldwide commodity. Its price is determined by supply and demand on the London Metal Exchange and in the international marketplace. The U.S. aluminum industry has absolutely no ability to pass on higher costs because of a domestic BTU tax. Coming on top of the increase in BPA's real costs, the energy tax proposal would make us uncompetitive. It definitely would force us to shut down in current aluminum markets and ultimately would drive our plant and many of the other aluminum smelters in the U.S. out of business.

The Administration's proposal recognizes some of these competitive pressures by quite properly providing a BTU tax credit for all aluminum exports. However, GATT rules prohibit applying the BTU tax to aluminum imports. Since additional freight costs almost always would be less than the proposed BTU tax, economic realities compel a producer to export production to avoid the BTU tax and import foreign aluminum to meet its metal requirements.[1] This means the tax will seriously harm the domestic aluminum industry without raising significant additional revenue for Treasury.

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1 A Northwest producer can export to the far east for about the same freight cost as sales in the midwest. Midwest customers would receive aluminum from Canada and other foreign producers. While this strategy may work (albeit with significant wasted costs) for large multinational producers, it wreaks havoc with independent domestic producers like us who have long-term sales obligations and can't pass on the BTU tax increases.

The Feedstock Exemption Should Apply to Aluminum

The problem is not just that the BTU tax ultimately will drive us out of business, but also that its imposition would be inconsistent with the intent of the energy tax and discriminatory. As a January 28, 1993 memo by the Joint Committee on Taxation about the design of a comprehensive energy tax stated, electricity is used as a "catalyst" in aluminum production just as coke is in steel production. The exemption that applies to coke and other feedstocks should also apply to the electricity used in aluminum reduction and the carbon used in aluminum anodes and cathodes.

In order to explain why electricity is a feedstock it might be helpful to briefly explain how aluminum is produced. Aluminum is produced by decomposing our raw material, alumina (Al_2O_3), into its components, aluminum and oxygen. This is accomplished by passing electric current through the alumina while it is dissolved in a solution of molten cryolite. Electricity is not used as a fuel in the traditional sense of producing heat or turning a motor. Instead, aluminum reduction requires the continuous flow of the electrons in an electric current to separate the strong electromagnetic bond between aluminum and oxygen atoms.[2] In a very real sense, aluminum is nothing more than "stored electricity" and the electricity truly is a feedstock in aluminum reduction.[3]

Congress should likewise clarify that the petroleum coke and coal derivatives used to build the anode and cathode of an aluminum reduction cell represent non-fuel feedstock uses. Electricity supplies a positive charge to the carbon anode that attracts the negatively charged free oxygen atoms like a magnet and stabilizes them in the form of CO_2. This use of carbon clearly is a feedstock just like coke in steel production. The carbon cathode also clearly represents a non-fuel use since it simply holds the molten aluminum and does not supply any energy to the process.

The feedstock exemption should be applied to electricity and carbon used in aluminum reduction, both because it is proper to do so and because application of the BTU tax would have serious adverse impacts on the ability of our plant and the U.S. aluminum industry to survive, without raising significant additional revenue for Treasury.

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2 Alumina (Al_2O_3) consists of two atoms of aluminum that each lack three electrons (Al^{3+}), and three atoms of oxygen that each have two excess electrons (O^{2-}). The six excess oxygen electrons fill the "holes" of the six missing aluminum electrons, bonding the atoms in a very tight, very stable compound. Electricity, which simply is a flow of electrons, is necessary to supply the missing electrons to the aluminum atoms in alumina to make electron neutral metallic aluminum (Al^0). Scientifically, electricity is a feedstock in aluminum reduction, fundamentally different than normal fuel-use of other electrical energy.

3 Electrical energy supplied in the smelting process is converted to chemical potential energy stored in the aluminum produced. This huge potential energy can be released through, for example, the aluminum battery currently under development and the powdered aluminum solid rocket fuel that launches the space shuttle.

Application of The BTU Tax On Hydroelectricity

I strongly believe that aluminum reduction should be exempt in total from the BTU tax. In addition, the way in which the BTU tax is applied to hydroelectricity should be modified.

The Administration has proposed taxing hydroelectric generation at the same rate as electricity generated by fossil fuels. However, hydroelectricity is a renewable resource and, in theory, should be exempt in total just as other renewable resources are exempt.

I am not advocating here, however, that hydroelectricity be totally exempt. But I do believe that it is improper and unfair to apply the same conversion factor to hydroelectricity as to other thermal generation. It simply is much more efficient to generate electricity from hydropower than by burning fossil fuels and running the steam through a turbine. In fact, previous Department of Energy calculations and standard international practice convert hydropower along with other renewable resources at a rate of 3,413 BTU's per kilowatthour rather than at the 10,000 BTU's of thermal energy required for a typical fossil or nuclear powered plant.

It not only is more accurate to use the lower rate of 3,413 BTU's per kilowatthour for hydroelectricity, but also much more fair. While the Pacific Northwest currently has lower average electricity rates because of our large supply of hydroelectric power, we also have higher average total energy costs because of our climate, lack of petroleum and other energy sources, long driving distances, and many energy intensive industries that the federal government encouraged to locate in the region. Electricity rates in the Northwest also are increasing dramatically, in large part to pay for the nation's most aggressive conservation program and to restore and enhance our endangered salmon fishery.

In short, it is both technically inaccurate and unfair to apply the same conversion factor to hydroelectricity as is applied to fossil fuel generation.

10% SURTAX APPLIED TO S-CORPORATION

The second issue I would like to discuss is how the proposed 10% "millionaire" surtax would affect S-Corporation related income. As proposed, the surtax would raise marginal rates for individuals with income above $250,000 to 39.6% for income other than capital gains.

The Administration also proposes to increase the maximum corporate tax rate to 36% in order to equal the higher basic 36% individual rate. There would not, however, be a surtax on corporate income as there is on individuals with high incomes.[4]

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[4] There is a maximum surcharge of the lesser of 3% or $200,000 on corporate income over $15,000,000. But this is intended to "recapture" the benefit of lower bracket corporate tax rates, not to add a surtax.

I do not plan to comment here on the increase in marginal tax rates. I do want to point out, however, that subjecting S-Corporation income to the 10% surtax is unfair and puts S-Corporations at a significant competitive disadvantage as compared to C-Corporations. The stated purpose for raising the corporate tax rate to the same 36% rate as the individual rate is to avoid inequities in the choice of business form. But the 10% surtax on individual rates conflicts with this purpose if it applies to S-Corporation income. It discriminates against the small business, high-growth, entrepreneurial enterprises that usually choose to be S-Corporations.

The obvious solution to this problem is to exclude S-Corporation income from the 10% surtax just as you propose to exclude capital gains income. Exclusion is appropriate since S-Corporation income is not the sort of passive, "millionaire" benefit from the 1980's tax structure that the surtax was intended to recapture. Instead, S-Corporation income is the active work-product of thousands of small businesses that generate our nation's job growth.

While I believe the Committee should adopt a general rule excluding S-Corporation income, it is especially important to do so in special cases like the situation facing Northwest Aluminum Company. Northwest Aluminum Company is an S-Corporation. While the vast majority of our earnings have been reinvested back into the company, we have a very generous profit-sharing plan that each year pays out 25% of our after-tax profits to all employees. It makes absolutely no sense to subject 489 hard-working union members and other employees to the "millionaire" surtax because the company is organized as an S-Corporation. At a minimum, if you do not provide a general exemption, the Committee should provide a special exemption for companies like Northwest Aluminum Company with a general profit-sharing plan set out in union contract.

In conclusion, we endorse your efforts to reduce the deficit even if it means that we will be paying higher taxes. However, we urge the Committee to correct two obvious oversights in the Administration's initial proposal by exempting the electricity and carbon used in aluminum reduction from the BTU energy tax and by exempting S-Corporation related income from the 10% surtax.

Thank you for the opportunity to present these comments. I would be pleased to answer any questions that you may have.

Mr. HOAGLAND. Thank you, Mr. Wilcox.
Mr. Boyle.

STATEMENT OF R. EMMETT BOYLE, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, ORMET CORP., HANNIBAL, OH

Mr. BOYLE. Mr. Chairman, members of the committee, I am Emmett Boyle, chairman, president, and CEO of Ormet Corp. I am extremely grateful for this opportunity to address the committee on the administration's proposed energy tax. This is a matter of vital importance for Ormet and for the entire U.S. aluminum industry.

Ormet is the fourth-largest producer of primary aluminum in the United States. We operate a smelter at Hannibal, OH, and an alumina refinery and a deep-water bulk marine terminal at Burnside, LA.

Ormet faces substantial increases in energy, transportation, and corporate taxes under the administration's proposal. Even so, we support the goal of decreasing the Federal deficit, and we understand that taxes need to be part of that effort, and we are willing to pay our fair share. But we should not have to bear the unfair and unreasonable burden. We should not be put at a serious competitive disadvantage.

Specifically, the present proposal makes no distinction between energy used to run our plants and equipment and the electricity that is used as an essential ingredient, if not a feedstock, in the production of primary aluminum. Both fuel and nonfuel energy would be taxed under this proposal.

The tax proposal grants exceptions to other industries for nonfuel energy. Petroleum used to make plastics will be exempt from this tax. Coal used to make coke, which is used for the production of steel, will be exempt from this tax. Natural gas used to make fertilizer may be exempt from this tax. But electricity used to make primary aluminum is not going to be given the same treatment. This is not fair, and it is not right.

Both plastic and steel are materials that compete with aluminum. I believe that the Government should not use its taxing power to pick winners or losers in this competition. Electricity is, indeed, a significant raw material in the aluminum smelting process. Ormet uses approximately 4.5 billion kilowatt hours of electricity annually. The bulk of the electricity is used as an ingredient to make our aluminum.

Our Hannibal smelter receives alternating current from a dedicated coal-fired generating plant. Most of that current is converted into direct current, which is then combined with carbon and alumina to produce aluminum. There is no other practical or commercial way to make aluminum. Therefore, we maintain that this nonfuel electricity deserves the same exemptions that have been properly granted to other nonfuel energy.

This tax will seriously damage our company's competitive position. The proposed Btu tax will increase the cost of production at our Hannibal smelter by 6.3 percent. It will increase the cost of Ormet's entire combined operation by 4.3 percent, and when combined with the proposed waterway tax, it will increase our cost of total production by 7.5 percent.

Ormet's total tax burden will increase by $15 million a year. For our company, this represents the difference between a small profit and a severe loss. Such a loss will have far-reaching effects.

Ormet directly employs 2,000 employees. An additional 20,000 indirect jobs depend on our manufacturing facilities. We spend more than $250 million annually for wages, benefits, and materials. All of these jobs and the expenditures would be put needlessly in jeopardy. Unfortunately, lost jobs and lost incomes are the only alternatives open to us. We cannot pass on the cost of a nonfuel tax. Aluminum is sold as a global commodity. Its price is set on a world market, and that price today is at a 40-year low. The world's selling price of primary aluminum today is actually lower than the average cost to produce it in the United States.

We cannot boost our efficiency to offset such a tax. Ormet nonfuel use of electricity is approximately 7 kilowatthours per pound. It is impossible to improve this without totally rebuilding our facility at an estimated cost of $2 billion.

Our dilemma is compounded when you consider that foreign producers of aluminum pay 22 percent less for electricity than we do. In some countries, our competitors pay 80 percent less than we do in the United States. They also have lower labor costs, abundant raw materials, less restrictive, if not nonexistent, environmental requirements. Such conditions are not surprising when you understand that foreign competition has driven one-third of U.S. smelters to close in the last decade. A discriminatory energy tax would drive even more jobs offshore.

Mr. Chairman, we do not ask for special treatment. We only ask for nonfuel use exemptions that have been granted to others.

Thank you very much.

[The prepared statement and attachments follow:]

Statement of
R. Emmett Boyle
Chairman, President and CEO
Ormet Corporation

Before the Committee on Ways and Means
U.S. House of Representatives

March 31, 1993

Mr. Chairman. Members of the committee. I am Emmett Boyle, Chairman, President and CEO of Ormet Corporation. I am grateful for this opportunity to address the committee on the administration's proposed energy tax. This is a matter of vital importance for Ormet and the U.S. aluminum industry.

Let me first introduce my company. Ormet is the fourth-largest producer of primary aluminum in the U.S. We operate a smelting facility in Hannibal, Ohio. We also have an alumina refinery and deep-water bulk marine terminal in Burnside, Louisiana, near Baton Rouge.

Ormet is a relatively large company. As such, it faces a substantial increase in energy, transportation and corporate taxes under the administration proposals. Even so, we support the goal of decreasing the federal deficit and we understand that taxes need to be part of that effort. We are willing to pay our fair share.

But we should not have to bear an unfair and unreasonable burden. We should not be put at a serious competitive disadvantage. Unfortunately, that is exactly what the proposed energy tax does.

Specifically, the present proposal makes no distinction between energy used to run our plants and equipment and electricity used as an essential ingredient, or feedstock, in the production of primary aluminum. Both fuel and non-fuel energy would be taxed.

The tax proposal acknowledges the fears of other industries about the serious impact it will have on them. It properly grants exemptions for their utilization of non-fuel energy. Petroleum used to make plastics is exempt from this tax. Coal used to make coke, which is used in the production of steel, is exempt from this tax. Natural gas used to make fertilizer may be exempt from this tax. But electricity used to make primary aluminum is not given the same treatment.

This is not fair. It is not right. Plastics and steel are materials that compete with aluminum. I believe the government should not use its taxing powers to pick winners and losers in this competition.

Electricity is a significant raw material in the aluminum smelting process. Ormet uses approximately 4.5 billion kilowatt hours of electricity annually. The bulk of that electricity is used as an ingredient to make aluminum.

Our Hannibal smelter receives alternating-current electricity from a dedicated coal-fired generation plant. Most of it is converted to direct current, which is combined with carbon and alumina to produce aluminum. The balance of the alternating current is used to power the plant.

This process was invented a century ago and there is no other practical or commercial way to make aluminum.

Therefore, we maintain that this non-fuel electricity deserves the same exemption that has been properly granted to other non-fuel energy.

Let me repeat that we support the administration's war on the deficit and we do not object to paying higher taxes on the energy used to run our plants and equipment. But a tax on non-fuel electricity is not fair. It also will seriously damage the company's competitive position.

The proposed Btu tax will increase the cost of production at our Hannibal smelter by 6.3 percent. It will increase the cost of Ormet's entire operation by 4.3 percent, and, when combined with the proposed waterways tax, will increase our cost of production by 7.5 percent. This is far more than Secretary Bentsen's 3 percent estimate.

Ormet's tax burden will increase by $15 million per year. For our company, this represents the difference between a small profit and a loss.

Such a loss will have far-reaching effects. Ormet directly employs more than 2,000 people. An additional 20,000 indirect jobs depend on our manufacturing facilities. We spend more than $250 million annually for wages, benefits and materials. All these jobs and expenditures would be put needlessly in jeopardy.

Unfortunately, lost jobs and income are the only alternatives open to us. We cannot pass on the costs of a non-fuel tax. Aluminum is sold as a global commodity. Its price is set on the world market, and that price is at a 40-year low, when adjusted for inflation. The world selling price is actually lower today than the average cost of U.S. production.

Nor can we boost efficiency to offset such a tax. Ormet's non-fuel use of electricity is approximately 7 kilowatt hours per pound. That is impossible to improve without totally rebuilding our facility at a cost of nearly $ 2 billion.

Our dilemma is compounded when you consider that foreign producers of aluminum pay an average of 22 percent less for electricity. In some countries, our competitors pay up to 80 percent less. They also have lower labor costs, abundant raw materials and less restrictive, or nonexistent, environmental requirements.

Meanwhile, the Clean Air Amendments of 1990 are expected to increase Ormet's energy costs by as much as 40 percent between now and the year 2000.

Under such conditions, it is not surprising that more than a third of U.S. smelters have closed during the past decade. A discriminatory energy tax would drive more jobs offshore.

Mr. Chairman, we do not ask for special treatment. We only ask for the non-fuel use exemptions that others have properly received.

More than 170 years ago, Chief Justice John Marshall wrote that "the power to tax involves the power to destroy." As citizens and taxpayers, the people of Ormet ask you to recall these words and the responsibility you bear in considering this tax proposal.

We ask you to use your taxing power wisely and fairly. Work with the Treasury Department to refine the proposal before it is introduced to the full Congress. Apply it justly to all industries. And protect the right of all Americans to compete freely and fairly in the global economy.

Thank you.

Ormet Corporation is among the top four producers of primary aluminum in the United States. It has combined experienced management, strategically located facilities and a dedication to quality to form a company that has achieved industry recognition.

Ormet's focus on quality and productivity is evident in the company's slogan, ***"A New Generation of Aluminum."*** But it's really more than a slogan—it's a way of life for the people of Ormet. Selected through a grass-roots employee effort, it exemplifies Ormet's attention to modernization and computerization. It speaks of a company made of people devoted to providing customers with the highest-quality products and service possible.

Focused On The Future

Although the company has been in operation more than 30 years, it took vigorous new leadership with imagination and zeal to make Ormet truly efficient and competitive. Led by R. Emmett Boyle, chairman, president and chief executive officer, this team has made major changes in capital improvements while maintaining the integrity of the facilities. Their aggressive marketing and innovative production techniques have brought the company rapidly forward to its present position as an industry leader. Hard work and creativity have helped Ormet secure satisfied customers and respect from peers.

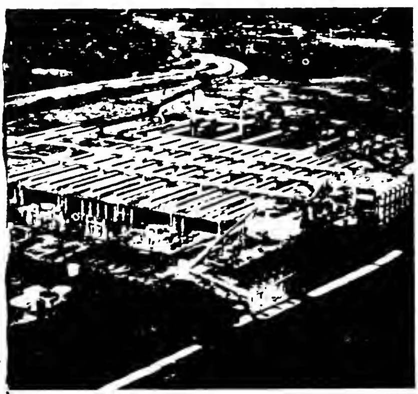
Ormet believes in solid investment in the future. The company has made over $60 million worth of capital improvements over a five-year period to make their plants more productive and efficient. This bold emphasis on modernizing facilities combined with enterprising management assures customers the highest-quality primary aluminum available anywhere.

Modern Facilities Positioned For Service

A review of Ormet's facilities shows how well the company has positioned itself. Ormet takes full advantage of access to raw materials and delivery to customer markets through the nation's central transportation systems, including water, rail, and highways.

Ormet Hannibal Reduction Plant

Ormet's corporate headquarters are located in Hannibal, Ohio, the site of the fourth-largest operating smelter in the United States.



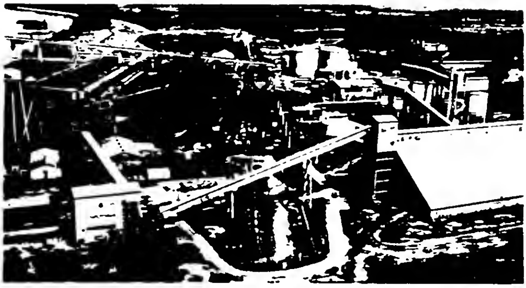
At capacity, this plant converts approximately 539,000 tons of alumina to 280,000 tons of aluminum per year. It employs more than 1,500 persons and covers 256 acres.

Ormet Cast House

Also located at the Hannibal complex, the Cast House is the focus of major capital improvements. Ormet's modern Cast House includes a Wagstaff *Air Slip* Casting System. This unit enables Ormet to produce *Satin Plus*, the most advanced fine-grained aluminum extrusion billet in production today. Phase II of the capital improvements invested an additional $12.5 million. The Cast House can produce primary ingots and extrusion billets to exact customer specifications.

Ormet Alumina Plant

One of the world's most efficient alumina refineries operates in Ormet's Burnside complex near Baton Rouge, Louisiana. The plant, located adjacent to Ormet's Burnside Bulk Marine Terminal, can convert 1,200,000 tons of bauxite to 600,000 tons of alumina products yearly. Its strategic location is a major reason for the corporation's cost-efficiency and on-time delivery record. The plant employs more than 300 persons.



Ormet Alumina Plant

▼ *Ormet Burnside Bulk Marine Terminal*

Ormet Burnside Bulk Marine Terminal

This deep water terminal is one of the largest of its kind in the Gulf Coast area, serving as the transfer point for cargo between ocean-going ships, river barges, railway cars, and trucks. The Terminal employs more than 130 persons and, situated adjacent to the Alumina Plant, gives Ormet a competitive edge in the shipping, handling and production of raw materials for producing aluminum. The Terminal's vast capacity far exceeds Ormet's current requirements for its own raw material handling, enabling Ormet to handle a variety of bulk materials for customers.

Ingredients For Success At Hannibal Reduction Plant And Cast House

Ormet has firmly positioned itself as a full-service company. Strict adherence to customer service is a vital element in Ormet's formula. Customers are pleasantly surprised by the attention they receive, uncommon in the heavy manufacturing arena.

State-of-the-art facilities and skilled labor are teamed with imaginative management in the Ormet formula. This equation spells customer satisfaction every time. Investing in the future, Ormet has instituted capital improvements and employee benefits that will lead the company into the 21st century.

At capacity, Ormet employs 1,500 persons at its Hannibal facilities and more than 2,000 corporatewide, with wages and benefits in excess of $80 million. This dedicated work force is a key element in Ormet's ability to keep costs down, production and quality high, and deliveries on schedule.

The corporation is devoted to meeting customer's needs and product specifications. At its Hannibal facilities, Ormet has three important service procedures in place to provide its high-quality aluminum products to clients:

Customer Inventory Reduction

A major portion of Ormet's aluminum production is dedicated to customers within a 500-mile radius of the Hannibal, Ohio reduction plant, assuring prompt delivery to all customers in the region. Ormet's goal is 100 percent on-time shipping. By keeping this performance promise, Ormet helps customers reduce their physical inventories and therefore inventory costs.

Individual Customer Service

Ormet's Sales Service Department is dedicated to making sure that all customers receive quality products made to their exact specifications on a consistent basis. Representatives from Ormet's Technical Department are available to visit any customer to answer questions or solve problems that arise in the use of Ormet metal.

Commitment To Quality

Ormet recognizes that good customer relations are the result of consistent delivery of quality products at competitive prices. All raw materials and finished products are analyzed routinely and statistical process control procedures are followed. Order after order, Ormet's quality and delivery are dependable.

The Hannibal facilities have an experienced sales and marketing staff eager to serve you and your company's needs. For further information, please contact:

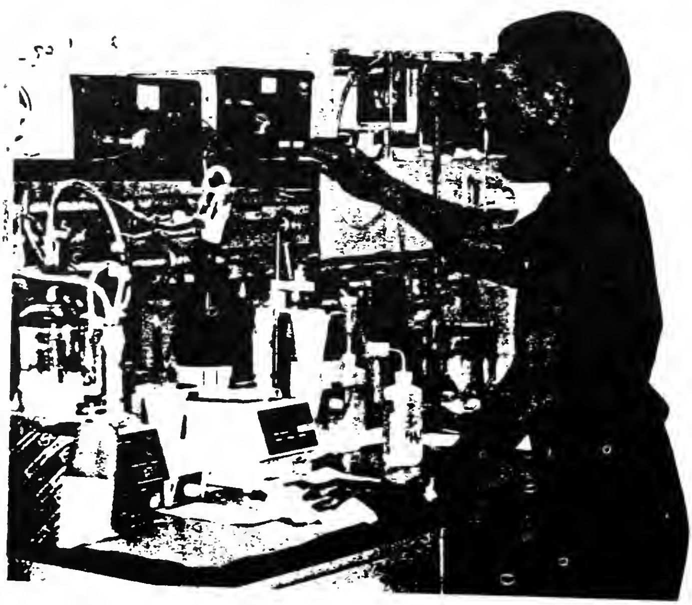
Ormet Corporation
Sales and Marketing Department
P.O. Box 176
Hannibal, Ohio 43931
614-483-2666

Ingredients For Success At Burnside Alumina Plant

As with all Ormet facilities, the Burnside Alumina Plant is equally dedicated to quality and customer satisfaction. With its diversified range of Enhanced Specialty Products and reduction-grade alumina, customer service procedures are somewhat different but no less important.

Quality Control

The Ormet Alumina Plant has its own modern, on-site laboratory for maintaining quality and system control. In the plant, analysis of manually-taken process samples combined with on-line sample analyzers guarantee the highest-quality process control available. Samples are taken, analyzed and recorded at dozens of strategic locations along the production line assuring the customer of the highest-quality product available.



Ingredients For Success At Burnside Terminal

Ormet's Burnside Terminal manufactures no products, so *service* is what it provides. Customers have relied on Burnside's 24-hour-per-day operation for more than 30 years.

Quality Control

At the Terminal, professional stevedores and modern, well-maintained equipment assure minimal product loss due to handling and elimination of any cross-contamination of cargoes. Burnside uses the latest technology and system control to ensure prompt, safe and efficient handling of all customer shipments.

Customer Service

The Burnside Terminal maintains Ormet's proud reputation for excellent customer service. At the Terminal, customized service means personnel handle each shipment on a priority basis. It also means stevedores work around the clock to meet shipping schedules and vessel traffic requirements. Whatever it takes, Ormet is dedicated to serving its customers.

Burnside's staff is eager to serve you and your company's needs for bulk cargo handling. For more information on services available, please contact:

Ormet Burnside Bulk Marine
Terminal Sales Department
P.O. Box 25
Burnside, Louisiana 70738
(504) 473-0793

How Aluminum Is Made

Aluminum is the most abundant metal on Earth and the third most common element, ranking only behind oxygen and silicon. It is one of the lightest, structurally useful metals known. When it is heat-treated and mixed with alloys, aluminum gains a strength-to-weight ratio that makes it extremely useful for applications in packaging, construction, transportation, wire and cable, furniture, utensils and more. The following guide will help you understand the steps involved in producing aluminum.

ORMET

1 Bauxite Mining

Bauxite, the principal ore of aluminum, is surface mined primarily in South American countries such as Brazil, Guyana, and Suriname, in Africa and in the Caribbean in Jamaica. It is transported by truck, rail, and ship to processing plants that convert it to alumina, the raw material from which aluminum is made.

2 Alumina Processing

The bauxite ore is reduced at the alumina plant to white powdered aluminum oxide (alumina). The process takes approximately two tons of bauxite ore for every one ton of alumina produced. As with the ore, the alumina powder is transported to aluminum plants by barge, truck and rail.

3 Aluminum Reduction

The processed alumina is reduced to aluminum at the reduction plant. As with the bauxite ore, it takes approximately two tons of alumina to make one ton of aluminum. Therefore, four tons of bauxite ultimately become one ton of aluminum. The alumina is processed in electrolytic reduction cells that produce an aluminum purity rate of more than 99 percent. Alumina is added to a bath of molten electrolyte at 1,775 degrees Fahrenheit producing molten aluminum.

4 Aluminum Processing

Molten aluminum is mixed with various alloys to match its metallurgical characteristics to the customer's specific needs. It is then cast into various shapes, again according to customer needs and specifications.

Aluminum may leave this step in the form of extrusion billets and primary reduction ingots.

5 Aluminum Products

The aluminum leaves the primary production plant in its various forms again by truck and rail for the customer's plant. In one or several more steps the aluminum is converted into products we all recognize and use regularly: airplanes, cans, furniture, ladders, kitchenware, signs, fasteners, automotive parts, housing, and more.

Aluminum remains lightweight and durable for years, requires little maintenance and is easy to recycle.

POSITION OF ORMET CORPORATION RE: APPLICATION OF NONFUEL USE EXEMPTION TO BTU TAX TO ALUMINUM INDUSTRY

A. Background

In its Summary of the Administration's Revenue Proposals" (the "Green Book"), the Department of the Treasury stated that a modified BTU energy tax shall include "exemptions or downstream credits... for nonfuel use and exports." The electricity used as a feedstock in the electro-chemical reaction necessary to produce pure aluminum should be included in this exemption.

Alumina, refined from bauxite ore, can only be converted to primary aluminum through an electrochemical process invented late in the last century. Electricity is combined with carbon as ingredients (or feedstocks) to smelt alumina. This process removes oxygen from the chemical structure of the alumina ingredient by breaking existing chemical bonds, linking the oxygen with carbon molecules as a byproduct and converts alumina into aluminum. Millions of kilowatt hours of electricity are required for this process beyond the electricity required for heat, light and to power plant equipment. This is truly a nonfuel use of electricity. The fuels required to produce electricity to heat, light and run plant equipment would still be subject to the BTU tax.

B. Rationale

An energy tax on coal, oil, or hydroelectric facilities would add tens of millions of dollars to the cost of each facility's annual domestic aluminum production since electricity costs will increase substantially. Such excessive new costs of production (approximately a 6% increase for Ormet) are not envisioned by a tax expressly designed to encourage consumer energy efficiency.

Treasury announced that the use of oil and petrochemicals to make plastics will qualify for the exemption. Also, the use of natural gas to make fertilizers will reportedly qualify. The rationale for those exemptions are virtually analogous to the aluminum example (because fuels are ingredients that alter the molecular composition of the products). The playing field should remain level since plastics are a primary competitor of aluminum (and are not as universally recyclable).

A nonfuel use exemption is easily implemented since both the utility and the manufacturer monitor the amount of AC (alternating current) power transferred to the facility which is converted into DC (direct current) for use in aluminum production.

The nonfuel use exemption should also apply to aluminum production for the following additional economic reasons:

1. Increased foreign competition. During the past decade over one-third of U.S. aluminum smelters closed due to higher electric rates, increased environmental costs and the proliferation of subsidized foreign competition.

2. U.S. net importer of strategic material. The U.S. has become a net importer of this commodity which is considered a strategic material for our national economy.

3. Costs cannot be passed on. Aluminum is sold as a commodity on the world market for a designated world price. Increased energy costs cannot be passed on to consumers since the price is fixed. That price is currently at a 40 year low (if inflation is considered); a price that is below the average cost of domestic U.S. production.

4. Foreign costs are less. Foreign producers have cheap electricity (often subsidized and 22 percent less on the average), low labor costs, abundant raw materials such as natural gas, bauxite and alumina, and less restrictive, or non-existent environmental regulations. Increased production costs will further disadvantage U.S. producers.

5. Jobs will move offshore; wages will decrease. Jobs will move offshore where production is already underway at reduced wages and production costs, or U.S. wages will be decreased to meet higher costs.

6. Foreign aluminum produced with tax-free electricity. Foreign competitors will, in effect, import tax-free electricity to the U.S. in the form of aluminum.

7. New environmental laws reduce profits. The Clean Air Amendments of 1990 increased production costs dramatically while depressed world aluminum prices also reduced profits.

8. Modernization capital more difficult to attract. Lower profit margins and higher operating costs will make capital required to modernize and remain competitive more difficult to attract.

We appreciate your consideration of the importance of the non-fuel use exemption to the States of West Virginia, Ohio and Louisiana (where Ormet operates) and to the U.S. aluminum manufacturing industry in this increasingly global economy. If you need further information or assistance in this matter, please contact Marc Scheineson (202) 835-8811 or Pat Quealy at 202-626-4784.

APPLICATION OF NON-FUEL USE EXEMPTION IN ADMINISTRATION'S PROPOSED BTU TAX TO ALUMINUM PRODUCTION AT ORMET CORPORATION

The Administration's proposed Btu tax includes an exemption from the tax for all non-fuel uses of the taxed energy sources. This exemption should include fuel consumed to produce electricity which is used as a material input in the production of aluminum. Without such an exemption the proposed tax will have a disastrous impact on the U.S. primary aluminum industry.

Ormet Corporation

- Ormet is a primary aluminum producer, with manufacturing facilities in Hannibal, Ohio and Burnside, Louisiana.
- Ormet directly employs 2000 people, most of whom are organized by the United Steelworkers of America, and it is estimated that over 20,000 indirect jobs are dependent upon or exist because of our manufacturing jobs. Domestically, Ormet spends over $250 million annually for wages, benefits, supplies and raw materials.
- Ormet uses approximately 4.5 billion KwH of electricity annually.
- Ormet also uses approximately 8.5 million MMBtu of natural gas annually in its operations.

Aluminum Market

- Ormet is struggling to survive in a volatile global marketplace where aluminum is a commodity traded on the international metals exchange. Excluding the Commonwealth of Independent States, U.S. domestic capacity (approximately 4 million Metric tons per year) represents only 26.6 % of worldwide capacity (approximately 15 million Metric tons per year).
- The aluminum production costs of foreign manufacturers are significantly lower than those of domestic producers due to subsidized power and low labor costs. With the exception of Germany, the cost of power for our

international competitors is significantly less than (1/2 to 2/3) domestic cost.

- Imports have risen by 41% and presently account for 19% of the U.S. aluminum market. Domestic capacity dropped in the period of 1978 to 1988 from 32 smelters to 22, and employment has likewise declined significantly. New smelting capacity is being located outside of the United States, where costs of production (primarily electricity) are significantly lower.

Description of Aluminum Production

- The only commercially feasible production process for primary aluminum utilizes electrochemistry and was invented by Charles Martin Hall in 1886. Electrochemical processes of an endothermic (adsorption of energy) nature have frequently supplanted purely chemical processes and in some cases have allowed the production of new products that could hardly be obtained in any other way. Aluminum can be commercially made only by fused salt electrolysis.[1] This process is still in use today around the world. The production of aluminum evolves from the basic raw material known as bauxite. This bauxite is processed into alumina (AL_2O_3) using a caustic digestion process known as the Bayer Process and then the alumina is converted into primary aluminum via Hall's electrolysis process.

- The basic feedstocks used in the electrolysis process are alumina, carbon anodes (coke and coal tar pitch) and electricity. The production of aluminum is a practical application of the electro-chemical equations first developed by the British scientist, Sir Michael Faraday and subsequently verified by others. In practice, primary aluminum is produced in an electrode reaction which results in the electro-deposition of the element aluminum at the cathode of an anode/cathode system commonly referred to as an aluminum reduction cell. The deposition of aluminum is measured in terms of weight of the production (or deposition) through Faraday's law expressed as:

$$W = (It/F)\ (A/n)$$

Where:

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[1] Chemical Engineer's Handbook, John H. Perry, Editor in Chief, 3d Edition 1950, p. 1772.

W is the aluminum deposition in grams measured by the flow of current, I, amperes, for a given period of time (t).

Equivalent weight of aluminum deposition is equal to its atomic weight divided by, n, which is the number of charges involved in the reaction.
F is Faraday's constant which is 26.8 ampere hours i.e. the amount of electricity required to produce one gram equivalent of aluminum.

This is the theoretical maximum which would be available as a feedstock to produce aluminum if the process were 100% efficient and all of the electrical current could be adsorbed, without any waste, as a raw material input to the production of aluminum.

- Over the years since Ormet was constructed in 1957-1958 several energy conservation steps have been taken to reduce the electrical energy requirements for its electrolytic production cells from approximately 7.8 kilowatt hours per pound to the present level of 7.25. This has improved the process efficiency from approximately 85% to over 92% of the theoretical maximum (beyond which the electrolysis of aluminum cannot occur) available according to Faraday's electro-chemical equations.

- For each pound of primary aluminum produced at Ormet Corporation's Hannibal, Ohio Aluminum Reduction Plant it requires approximately 1.92 pounds of alumina, about 0.45 pounds of carbon anode and approximately 7.25 kilowatt hours of electricity. As such, electricity is a basic feedstock for which there is no substitute. It accounts for up to 35% of the cost of aluminum production and long-term dependable supplies of large blocks of power are the life-blood of the industry.

- The electricity used in creating the chemical reaction necessary to produce aluminum is not used to power machinery or provide lighting, but is an "ingredient" in the recipe for aluminum, just as coke is an ingredient in the recipe for steel or oil is an ingredient in the recipe for petrochemicals as well as plastics. (Attached for reference is a memorandum prepared by Hank Guttman and Ben Hartley, staff to the Joint Committee on Taxation dated January 28, 1993 which discusses energy taxes, the non-fuel use exemption and its application to aluminum manufacturing.)

Proposed Btu Energy Tax

- The proposed Btu tax would have a disproportionate impact on Ormet and the aluminum industry in general because of its need for and use of significant blocks of electricity in the domestic aluminum production process. The tax would have a disastrous impact on the aluminum industry as compared to other manufacturing interests. In fact, Ormet was recently advised that a prospective lender is no longer interested in lending capital to U.S. aluminum plants affected by the energy tax proposal.

- The non-fuel use exemption should apply to the aluminum industry because electricity is a feedstock in the production of aluminum.

- Such a tax would add a considerable financial burden to Ormet which is already facing a substantial increase in costs as a result of its utility's efforts to comply with Title IV (Acid Deposition Control) of the Clean Air Amendments of 1990 (Clean Air legislation).

Implementation of Exemption

- The non-fuel use exemption could be easily implemented in the aluminum industry. For example,

- Ormet purchases electricity directly from a specific and totally dedicated utility-owned generating plant.

- The electricity is delivered to the facility as AC power (alternating current), where Ormet rectifiers convert it into DC power (direct current) to be used in the production of aluminum. About 2 1/2 percent of the inputed electricity is lost through this conversion process. For example, 100 Kw hours of AC power would be converted through this process into 97 1/2 Kw hours of DC power. This conversion takes place at the plant not at the utility.

- Ormet meters the amount of AC power coming into its facility and at the end of each month has documentation of the exact amount of AC power supplied by the utility and converted into DC power.

- The amount of power used for the ancillary support functions can also be identified.

Competitive Issues

- During the past decade over one-third of the smelters in the U.S. were forced to permanently close due to higher electric rates in the U.S. and the proliferation of subsidized foreign competition. The proposed new energy (Btu) tax would add an additional onerous cost burden to a U.S. industry already in a precarious position relative to foreign competition. In the case of Ormet, the energy tax would be applied to fuel used by the utility that generates Ormet's power under a "dedicated facility" contract and at a specific generating station that uses coal as fuel. Under the contract, a cost plus contract, an energy tax on the fuel used at this generating station will be passed on directly to Ormet.

- The aluminum industries in other countries have cheap (often subsidized) electricity, low labor costs, abundant raw materials such as natural gas, bauxite and alumina, and less restrictive or non-existent environmental regulations. Primary aluminum is a commodity traded on world exchange markets. Thus, producers of primary aluminum have no control over the market price of primary aluminum ingot. A commodity's selling price does not reflect its production cost. If Congress legislates the significant increase being considered in the form of the Btu energy tax, the 2000 direct jobs at Ormet would be seriously threatened.

- The domestic aluminum industry competes with international competitors whose energy costs are significantly less and in some cases roughly one-half those of domestic producers. In the United States aluminum electricity costs average 2.13 cents/Kwh. By contrast, in Canada these same costs average only 1.12 cents/Kwh. U.S. aluminum producers are already at a 22 percent disadvantage compared to the average for all other worldwide producers.

- The imposition of the proposed Btu tax, when fully phased-in, would add $12.6 million to our annual production costs of which $10.5 million is directly attributable to our feedstock use of electricity. This would severely disadvantage Ormet competitively and potentially put us out of business.

- Unlike larger U.S. producers, Ormet's facilities are located entirely in the United States. Ormet will not be able to follow the logical reaction of these other producers by shifting production off shore to avoid the tax. Similarly, foreign competitors will in effect be

able to import electricity to the United States in the form of aluminum which will not have an energy tax included in the sale price.

Impact of Clean Air Legislation

- The impact of the Clean Air legislation on Ormet will cause a significant increase in the cost of this raw material which translates into millions of dollars per year of additional costs to be borne directly by Ormet.

- Ormet obtains its power pursuant to a long-term dedicated facility contract in which all costs incurred in generating electricity for Ormet is passed through to Ormet. Ormet is directly billed for all costs of fuel operation, maintenance and capital including environmental compliance costs and any excise or ad valorem taxes imposed by local, state or federal authorities. Thus, all costs of the Clean Air legislation will be passed directly on to Ormet.

- Ormet's smelter is located in the Ohio Valley and it cannot balance increased production costs off against production facilities in other parts of the country or the world. Thus, the legislation has adversely affected the competitive position of the company with other domestic and international producers that do not face the same restrictions.

THE WHEELING INTELLIGENCER
Saturday, March 20, 1993
1 OF 1

PAGE 4

Ormet's Concern

Apparently the size of the shares varies substantially when it comes to President Clinton's "shared sacrifice" philosophy regarding new taxes. A vital local industry, Ormet Corp., appears in line to take a much heavier hit than seems fair.

This is disturbing for hundreds of Ohio Valley residents whose jobs at the plant in Hannibal depend on Ormet's ability to compete in a global marketplace.

Aluminum smelting requires a tremendous amount of electric power, and Ormet would pay a great deal more for that power under Clinton's proposed energy tax.

The timing couldn't be worse. Domestic aluminum makers have just begun climbing out of a deep financial hole which opened during the 1970s and 1980s. Huge investments in new equipment, sacrifices by workers and improvements in productivity have helped make American aluminum marginally competitive again. Recovery is by no means complete, however, and the energy tax threatens to make matters a whole lot worse.

Ormet CEO Emmett Boyle says the tax could increase aluminum industry costs by 6 percent. That's in addition to the staggering 40 percent surge in power costs expected over the next seven years because of the job-killing Clean Air Act of 1990. Clearly, it's a burden the aluminum industry will find it tough to overcome — particularly because foreign competitors face neither cost increase.

There's another catch. Boyle says the Clinton administration may try to help other industries cope with the energy tax. Under consideration is a break on petroleum used to produce plastics, for instance. For many applications, plastic competes with aluminum. That means aluminum producers would be pounded while a major rival gets a break.

Boyle is trying to convince the administration to make its "shared sacrifice" tax plan less discriminatory. Certainly, for the hundreds of Ormet workers who already have sacrificed, as well as for our area's less than robust economy, Boyle's point seems valid.

U.S. Aluminum Makers Hit Downside of Going Global

Overseas Slumps Take Harsh Toll Due to Industry's World-Wide Nature

By Dana Milbank
Staff Reporter of The Wall Street Journal

American aluminum producers built an an empire across the world even before "going global" became popular. But these days, this pioneering industry is feeling a bit homesick.

As other U.S. industries roar back to health, the aluminum business is entering the third year of its deepest slump ever, with little prospect for much improvement in 1993. With real aluminum prices at their lowest in history, virtually all major producers have dipped into the red.

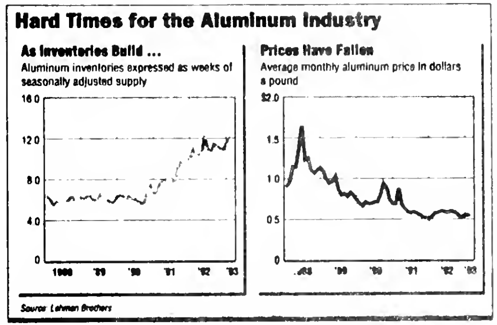
Reynolds Metals Co., the No. 2 producer, has already forecast a first-quarter loss. And analysts say industry leader **Aluminum Co. of America**, despite a much ballyhooed cost-cutting effort, would be losing money now without its production of alumina (a powder used to make aluminum and other products).

The worst part is that, because of the industry's international nature, the North Americans are largely powerless to fix the problem. Despite record shipments in the U.S., weak economies in Europe and Japan and a surge in exports from the former Soviet Union are depressing prices on world markets, which dictate U.S. prices.

"We're doing whatever we can to compete against the rest of the world, and it's an uphill fight," says Emmett Boyle, chief executive of Oralco Inc., a Wheeling, W.Va., aluminum company. "The United States has already taken a tremendous beating." Mr. Boyle says the U.S. has shut down 10 of its 32 aluminum smelters in the last 15 years and sold technology to foreign producers that benefit from lower energy and labor costs.

While American companies in many industries, from chemicals to consumer products, have been affected recently by troubles overseas, aluminum makers have a bigger problem because they have more international exposure. Alcoa had 40% of its sales and 13% of its identifiable assets in foreign lands in 1992. The percentages for Reynolds Metals were 25% and 36%.

And while more parochial industries such as American steel have been able to ratchet up prices domestically in part because of protection from foreign steel,



aluminum makers have no such luxury. Since 1978, aluminum prices have been set on the London Metal Exchange, putting U.S. producers at the whim of overseas traders.

"If the demand is weak abroad, it's almost as bad as if demand is weak domestically," says Lloyd T. O'Carroll, Reynolds Metals' chief economist. "The London Metal Exchange doesn't care where the metal is."

Rising U.S. Demand

U.S. aluminum demand was actually up some 10% last year and continues to climb to record levels, as American producers gain market share in new products. At the same time, U.S. production will drop about 8.5% this year, Lehman Brothers analyst Thomas M. Van Leeuwen predicts, because of cutbacks forced by drought in the Pacific Northwest.

That should mean higher prices for U.S. producers – but it doesn't. While U.S. producers cut production, output is rising in Canada, Europe and the Middle East. And because of slack demand in Japan and Europe, world-wide aluminum growth is flat. As a result, Mr. Van Leeuwen says, "This industry is up to its eyeballs in inventory. The 12 week oversupply, nearly double healthy levels, could take a year to work off. That, in turn, has kept aluminum prices around 55 cents a pound, down from a peak of $1.65 in 1988.

Aggravating the situation is the flow of metal from the former Soviet Union. Because of deflated demand at home and a need for cash to prop up the economy, these countries, beginning in late 1990, have boosted exports from under 300,000 tons annually to some 1.2 million tons – equivalent to 8% of Western production.

"It means we cede any growth in our market to them for three years to absorb that kind of volume," says Roger Scott Taggart, director of industry analysis for Alcan Aluminium Ltd., the Canadian producer. Thanks to the cheap ruble, the Russian mills are profitable. Thus shipments are likely to continue, and may ultimately include finished aluminum goods, causing more damage to American producers, he adds.

At the same time, Western European producers have shown little appetite for cutbacks. Unprofitable, state-owned producers such as Italy's Alumínio SpA and Spain's Alumínio Español SA and Inespal continue to pump out metal. The Norwegian producer, Norsk Hydro, has returned to its previous output after calling for cutbacks.

'Collective Lunacy'

Stewart Spector, an analyst who writes the Spector Report, calls the situation "collective lunacy." Virtually every smelter in the world lost money in 1992, dragging down fabricated prices and dropping margins for can sheet, the industry's biggest product, near all time lows.

The oversupply could force American producers to keep their capacity idle in the Pacific Northwest and to look for deeper cuts. "This cannot be sustained," Mr. Spector says. "If it stays bad until 1995 or 1996, there will be financial disaster in the aluminum industry."

With prices set internationally, U.S. aluminum producers can't easily pass along higher costs to their customers. For this reason, the Clinton administration's proposed energy tax makes them particularly nervous. The Aluminum Association warned that unless the proposed tax exempts electricity used as an ingredient in the aluminum making process, "the U.S. primary aluminum industry and its 24,000 jobs will be jeopardized." Aluminum is made through a chemical reduction process that requires high levels of electricity.

The tax would add only two cents a pound to producers' costs, and new technology could eliminate the cost altogether. But, says Oralco's Mr. Boyle, "a couple of cents a pound is enough to sink your ship today." At the same time, Mr. Boyle says, Clean Air Act amendments could increase his energy costs 40% by 2000.

Aluminum producers believe that their cost-cutting and marketing efforts will help them outlast their international troubles. In the end, they believe, most aluminum growth will come from abroad. But they have also learned the perils of going global. "The U.S. industry didn't understand [international developments] would keep hitting us with problems one after another," Reynolds's Mr. O'Carroll says. "The international nature of the business makes the entire cycle more volatile."

Mr. HOAGLAND. Thank you, Mr. Boyle.
Mr. Frank.

STATEMENT OF JAMES S. FRANK, MEMBER, BOARD OF DIRECTORS, AMERICAN AUTOMOTIVE LEASING ASSOCIATION, AND PRESIDENT, WHEELS, INC., DES PLAINES, IL

Mr. FRANK. Thank you, Mr. Chairman and members of the committee.

I am Jim Frank, president of Wheels, Inc., a privately owned firm headquartered in the Chicago area, providing automotive leasing and fleet management services to American business.

We lease in excess of 135,000 vehicles, 99 percent of which are manufactured by General Motors, Ford, and Chrysler. I appear today as a representative of the American Automotive Leasing Association, the trade group representing the commercial fleet leasing business. Our members primarily provide vehicles to be utilized in commercial sales and service fleets, a market which exceeds 3½ million vehicles.

I am here today to urge you to correct the inadequate depreciation allowance for automobiles in the current law. Correcting this error will provide the incentive effect you seek for a fundamental American industry, while at the same time eliminating taxation on nonexistent income. This change should certainly be made before incentives in the form of tax subsidies are provided to others.

In 1986, the Tax Reform Act specified that the 3-year depreciation recovery period for automobiles be lengthened to 5 years, an increase of 66 percent. In 1989, Congress directed Treasury to again study the proper class life for automobiles, and the Treasury Department issued a report confirming that 3 rather than 5 years is the correct recovery period for business use automobiles.

The 1986 act authorized Treasury to reclassify automobiles to a 3-year life if the facts warranted the change. Treasury's authority, however, was subsequently eliminated based on Congress' desire to prohibit Treasury from lengthening the recovery periods for other groups of assets, thereby ironically locking automobiles into an excessively long recovery period.

Because business users of automobiles now pay tax based on a 5-year instead of a 3-year recovery schedule, they are adversely impacted in two ways. First, in contrast to most asset classes, investment in business use automobiles does not benefit from any incentive depreciation.

Second, under the alternative minimum tax, failure to allow economic depreciation actually overstates income, directly contrary to the AMT's purpose of taxing on the basis of real economic income.

One of the goals of the proposed legislation is to provide investing incentive to businesses. Correcting the recovery period for automobiles will provide that exact stimulus, while additionally correcting the error from the 1986 act that resulted in users of business automobiles being allowed less-than-true economic depreciation.

Lowering the cost of business use vehicles by providing adequate economic depreciation will result in increased sales of automobiles as fleet users both expand their fleets and accelerate replacements.

Since over 95 percent of the vehicles purchased by our industry are manufactured by the 3 domestic manufacturers, the American

automobile industry and its many associated suppliers, which include the aluminum industry, would clearly benefit from this legislation.

Finally, I would like to comment briefly on the proposed incremental investment tax credit. We agree that leasing should not be used to circumvent the intent of the legislation. The tax laws should not, however, limit a business' financing options and should not prefer purchasing over leasing.

As described in our written submission, we encourage you to include the user's leased and owned assets in calculating both the base and incremental aspects of the investment tax credit. This is a simple way to achieve the intent of the incremental credit, while retaining neutrality in the purchase or lease decision.

Thank you for providing us this opportunity to address you today.

[The prepared statement follows:]

Statement of
James S. Frank
American Automotive Leasing Association
on the Administration's Proposals
for Economic Stimulus and Deficit Reduction
Before
The Committee on Ways and Means
United States House of Representatives

March 31, 1993

Mr. Chairman:

My name is James S. Frank. I am the president of Wheels, Inc., of Des Plaines, Illinois, and am testifying on behalf of the American Automotive Leasing Association. AALA is composed of companies who lease and manage the majority of sales and service vehicles used by businesses throughout our country, a market exceeding three and a half million vehicles. We want to thank you for giving us the opportunity to present our views of the President's tax program and tax changes which would help economic growth.

I would like to address three issues: the unfair tax treatment of business-use automobiles under the present capital cost recovery rules and its negative effect on the sales of domestic automobiles, the impact of this discrimination against business-use automobiles on the Administration's alternative minimum tax proposal, and issues under the proposed incremental investment tax credit that pertain particularly to leasing.

3-Year Depreciation Period for Automobiles

In general, we strongly urge the Committee to reduce the cost recovery for automobiles to three years. Automobiles have traditionally been depreciated over three years. Unfortunately, in 1986, Congress lengthened the write-off period to five years, evidently based on misinterpretation of data regarding the useful life of these vehicles.

Since that time, it has been made absolutely clear that classification of automobiles as five-year property is wrong, and that a three-year life is appropriate.

The Omnibus Budget Reconciliation Act of 1989 directed the Treasury Department to conduct a study of the proper class life of cars and light trucks. The Treasury Department issued a report in April, 1991, which recommended a class life of 3.5 years for business-use cars, and, in fact, concluded that the actual adjusted economic life for cars used in business fleets is 2.8 years.

The 1991 Treasury Department report is just the latest in a long line of Treasury determinations that cars should be depreciated over a 3-year period. The earliest determination was made in Bulletin F, an I.R.S. list of guideline lives for depreciable assets promulgated in 1942. In 1962, the Treasury Department issued new depreciation guidelines in Revenue Procedure 62-21 and once again provided for a 3-year class life for automobiles. Finally, in 1971, the Treasury Department issued new "asset depreciation range" ("ADR") guidelines which were based on the 1962 guidelines, but allowed taxpayers to select a class life within a 20 percent range around the mid-point life. Cars were assigned a mid-point class life of 3 years.

Absent legislation to the contrary, an asset with a 3.5 year class life would be treated as three-year property for tax purposes. However, the 1986 Act specified that passenger cars placed in service after December 31, 1986, and before January 1, 1992, were to be classified as five-year property. After that period, the Treasury Department was given the authority to reclassify cars and light trucks as appropriate.

The reason for giving this background is to point out that, when the cost recovery period for cars was lengthened to five years, Congress intended that the five-year write-off period was to be required only through 1991, presumably to balance revenues to the Treasury over that period. After 1991, the Treasury Department was given authority to reclassify cars as three-year property if it deemed the shorter period to be appropriate based on economic useful life of the asset.

Unfortunately, in 1988, Congress enacted legislation that removed the Treasury Department's authority to reclassify assets as appropriate. While that change was intended to keep Treasury from lengthening cost recovery periods for certain assets without clear Congressional direction, it had the effect of locking cars into an inappropriately long recovery period.

Congress is now considering various tax incentives to promote economic growth. In this context, we respectfully urge adoption of a three-year cost recovery period for business-use cars.

Shortening the cost recovery period for passenger cars would not be an incentive of some arbitrary amount, but would, rather, simply provide these assets with a cost recovery period that accurately reflects their usefulness in business. Nevertheless, shortening the cost recovery period to three years for business-use cars would also be one of the most effective and targeted tax incentives that the Government could provide.

Perhaps a little background would be helpful to show the benefits of returning cars to a three-year recovery period. Businesses are very good customers of our domestic automobile manufacturers. More than 95 percent of business-use cars are products of domestic manufacturers. Over 125,000 businesses have fleets of ten or more automobiles. Business-use cars also account for over one-third of all automobiles sold by domestic manufacturers -- over 3.5 million cars per year.

Reducing the cost recovery period directly reduces the cost of a vehicle. A conservative measure of the value of this change alone would be to reduce the cost of a vehicle by 3 percent or more. If the cap on depreciation over the normal recovery period were raised to reflect real-world cost of these vehicles, to $20,000 for example, the cost of a vehicle would be reduced by 5 percent or more.

It is generally agreed in the industry that a reduction in price will result in an increase in sales of an equal percentage. In the business context, the increase in sales will occur both because businesses will operate more automobiles and because they will replace their fleets more often.

Thus, merely providing these vehicles with the depreciation rules which reflect economic reality will increase sales and result in more economic growth and more jobs, not only in automobile manufacturing directly, but also in industries such as steel, glass, rubber, textiles, and semiconductors that supply the automobile manufacturers.

AMT Depreciation

The 1991 Treasury Department report makes absolutely clear that a five-year cost recovery period is longer than true economic depreciation. Nevertheless, under present law, taxpayers are forced to use a five-year period for automobiles used in their business. This is absolutely contrary to the intent of the AMT to tax no more than economic income. Simple fairness requires that the AMT cost recovery period for cars be shortened to reflect economic depreciation.

As I mentioned earlier, the Treasury Department's 1991 study concludes that an appropriate class life for business-use cars would be 3.5 years. Thus, the cost recovery period

for cars under the AMT should be no more than 3.5 years to reflect economic depreciation, not the 5-year period provided under present law.

The Administration has determined that the depreciation provisions of the AMT are too onerous and operate as a disincentive to investment. As a result the Administration has proposed that taxpayers be allowed to use the same cost recovery for AMT purposes as they use to compute their regular tax liability.

While allowing the same cost recovery period for both regular tax and AMT purposes would shorten the AMT cost recovery period for most assets, this change would provide no benefit for automobiles because of the artificially long period now provided for these assets for regular tax purposes.

Thus, although the Administration intends to improve AMT depreciation to remove disincentives to business investment, unless the cost recovery period for cars is specifically addressed, this important class of assets will be denied the benefits of the proposal.

Investment Tax Credit

Finally, I would like to address the Administration's proposals to reinstate an investment tax credit. I know that you have already heard much about the value of an investment tax credit. Other than suggesting that equity might indicate that enacting an appropriate cost recovery period for automobiles should be have a higher priority than enacting a new incentive, I will limit comment to aspects that have a particular effect on the automotive leasing industry.

First, we can understand the Treasury Department's concern that leasing should not be used to circumvent the incremental element of the proposed ITC. If the intent is to limit the ITC to taxpayers who increase their business investment, it may be entirely appropriate to prohibit taxpayers who have no real increase in investment from leasing from someone else who will be able to show such an increase. Similarly, we believe that taxpayers who currently lease should not be able to show an increase in their investment base simply by shifting to ownership.

On the other hand, it is very important that any such limitations must not be drafted in a way that will encourage taxpayers to purchase rather than lease assets.

One simple way to protect the intent to require an increase in investment over a historical base in order to qualify for an ITC and, at the same time, avoid influencing the purchase/lease decision, would be to include both owned and leased assets in the lessee's investment base. We submit that, in order to avoid prejudicing the purchase/lease decision, fair market value of a leased asset be included in the lessee's investment base. This is the rule that was used under prior law to value the ITC when passed through to the lessee.

Obviously, for very short-term leases such as rental car arrangements, inclusion of an asset in the lessee's base may be impractical. However, a standard automobile lease is for a term of one year with renewals at the option of the lessee. The typical leased vehicle is used for 24 to 30 months and disposed of as quickly as possible after coming "off lease." Since these arrangements are direct substitutes for ownership, we would urge that you should treat these leases as long-term leases of assets which should be included in the lessee's investment base.

Mr. HOAGLAND. Thank you, Mr. Frank.
Mr. Correll.

STATEMENT OF DONALD L. CORRELL, VICE CHAIRMAN, GOVERNMENT RELATIONS COMMITTEE, NATIONAL ASSOCIATION OF WATER COMPANIES, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, UNITED WATER RESOURCES, HARRINGTON PARK, NJ

Mr. CORRELL. Good afternoon, Mr. Chairman and members of the committee. My name is Don Correll. I am president and chief executive officer of United Water Resources, a water utility holding company located in Harrington Park, NJ. I am also a director of the National Association of Water Companiess and vice chairman of its government relations committee.

The NAWC is the trade association representing the Nation's investor-owned water utilities. Its 360 members in 41 States provide safe, reliable drinking water to over 22 million Americans every day. In my State of New Jersey, NAWC members provide drinking water to 40 percent of the population. Our members employ a combined work force in excess of 15,000. Last year, these companies had operating revenues of $2.3 billion and gross utility plant investment of $9 billion.

My statement today focuses on investment incentives in the President's budget proposal and ways to strengthen these proposals.

During the past year, much has been said about the state of the Nation's infrastructure. These references have generally been to bridges, highways, and mass transportation systems. But a water system is the most basic example of infrastructure. Although often taken for granted, arrangements must be made to develop an adequate supply of safe drinking water before any new homes or any new businesses can be built.

Our industry welcomes Federal policies that provide direct incentives to private sector infrastructure investment, such as the investment tax credit and reform of the alternative minimum tax. Investment incentives for our industry are desirable for several reasons. They will stimulate both an increase and an improvement in the Nation's existing drinking water infrastructure and create manufacturing and construction jobs to produce and install water utility facilities. From an environmental perspective, investments in our industry will help ensure compliance with Federal drinking water quality standards.

Since the passage of the Safe Drinking Water Act Amendments of 1986, numerous water quality regulations have been adopted, imposing huge capital requirements upon the Nation's water utilities. The EPA estimates compliance capital costs of $2½ billion a year over the next decade. In addition to the approximately $10 billion a year in annual infrastructure needs water suppliers face over the same time period. Enactment of the ITC could accelerate these investments.

I urge the committee when reinstating the ITC to also reinstate the protection of the credit afforded by the Revenue Act of 1971, as amended by ERTA. Without such protection, the credit might be flowed through to customers immediately through the rate setting

process, reducing the effectiveness of the ITC as an investment incentive and defeating the credit's very purpose.

We also favor the President's proposal to modify the alternative minimum tax depreciation method. Simplifying this complicated area of the Tax Code reduces the AMT's disincentive to infrastructure investments.

Like many other associations, we would prefer to see the top corporate rate remain at 34 percent, but we understand serious deficit reduction requires serious measures. However, our industry has a somewhat unique concern regarding the proposed 36 percent corporate tax rate on income over $10 million. State utility regulators require us to operate as separate companies in each State. Although a utility holding company may have consolidated income far above $10 million, its subsidiaries may have income less than $10 million. In such a scenario, some State public utility commissions might only allow the subsidiary to recover the tax at the 34 percent rate, even though it is paying a marginal rate of 36 percent on a consolidated return.

This treatment will potentially delay needed infrastructure investments, a result directly counter to the goals of the President's proposal.

Finally, we urge the committee to include in legislation encompassing the President's proposal a provision excluding from gross income, contributions in aid of construction, CIAC, to a water or waste water utility. Including CIAC in gross income merely subjects utility capital to an income tax, a tax that must be collected from our customers. This causes us to lose business, increases the price of new housing by as much as $2,000 a unit, and leads to the creation of poorly run water systems. Each of these results only aggravates the Nation's infrastructure and water quality problems.

Congressman Bob Matsui has introduced H.R. 846, revenue neutral legislation to restore the exclusion of water and waste water CIAC from gross income. So far, he has been joined in this effort by Representatives Jacobs, Archer, Coyne, Kopetski, Herger, Kennelly, Sundquist, Johnson, and Thomas of this committee. Given support for this noncontroversial legislation by other Members of Congress as well, I hope you will include it in the President's package when you meet to consider it.

Mr. Chairman, the NAWC is ready to work with you and the President. I am grateful for this opportunity to testify before you today, and I am happy to answer any questions you may have.

[The prepared statement follows:]

TESTIMONY OF
THE NATIONAL ASSOCIATION OF WATER COMPANIES
PRESENTED BY
DONALD L. CORRELL, PRESIDENT AND CEO
UNITED WATER RESOURCES

Good morning Mr. Chairman and members of the Committee. My name is Don Correll. I am President and Chief Executive Officer of United Water Resources, a water utility holding company located in Harrington Park, New Jersey. I am also Vice-Chairman of the Government Relations Committee of the National Association of Water Companies.

The National Association of Water Companies (NAWC) is the trade association representing the nation's investor-owned water utilities. Its 360 members in 41 states provide safe, reliable drinking water to over 22 million Americans every day. However, this statistic may be deceiving. In many states, the investor-owned water utilities are a significant presence. For example, in New Jersey, investor-owned water suppliers provide drinking water to 40 percent of the population. Our members employ a combined work force in excess of 15,000. In 1991, these companies had operating revenues of $2.3 billion and gross utility plant of $9 billion. Shares in 18 of our largest member companies are publicly traded.

Mr. Chairman, you know as well as anyone of the public response to President Clinton's economic address to Congress on February 17th. In it, he challenged Congress and the American people to join him in an effort to create jobs, reduce the deficit and provide for long-term economic growth. Our sector of the economy is certainly willing to provide the President all the assistance it can in this effort.

INVESTMENT INCENTIVES

Private investment is the key to the continued growth of the American economy. We welcome federal policies that provide direct and indirect incentives for private-sector investment. Direct incentives include the investment tax credit and reform of the alternative minimum tax, while the primary indirect incentive is the expected reduction in interest rates paralleling deficit reduction.

During the past year, much has been said about the state of the nation's infrastructure. These references have generally been to bridges, highways and mass transportation systems. These are undoubtedly significant elements to our economic well-being. But a water system is the most basic example of infrastructure. Although often taken for granted, arrangements must be made to develop an adequate supply of safe drinking water before new homes and businesses can be built.

From the perspective of the President's economic plan, investments in our industry are desirable for several reasons. First, they will stimulate an increase in drinking water infrastructure. This is a prerequisite for economic development. Second, they will mean an absolute improvement in the nation's existing drinking water infrastructure. Third, they will create manufacturing and construction jobs to produce and install water utility facilities. From an environmental perspective, investments in our industry will help ensure compliance with federal drinking water quality standards for years to come.

Our industry is favorably disposed to the President's investment incentives. For example, many of our companies will be able to take immediate advantage of the investment tax credits. Since the passage of the Safe Drinking Water Act Amendments of 1986, numerous water quality regulations have been adopted that impose huge capital requirements upon the nation's water utilities. The EPA estimates that compliance with the Safe Drinking Water Act will impose capital costs of $2.5 billion a year over the next decade on all water suppliers. This is in addition to the approximately $10 billion in annual infrastructure needs water suppliers face over the same time period. Investor-owned water utilities' share of these costs is conservatively estimated at $6 billion during this decade.

Enactment of the ITC is likely to accelerate these investments, thereby safeguarding drinking water quality and creating both manufacturing and construction jobs, as well as developing infrastructure for economic growth. A 1992 study entitled A Report on Clean Water Investment and Job Creation provides an estimate of between 34 and 58 new jobs created per $1 million additional spent on such projects. Using these figures, $6 billion invested in our industry could generate directly and indirectly between 200,000 and 350,000 jobs. In addition, by lowering the cost of capital, in some cases the ITC can reduce the need for rate increases to finance these huge capital requirements.

I urge the Committee when reinstating the ITC to also reinstate the protection of the credit afforded by the Revenue Act of 1971 as amended by the Economic Recovery Tax Act of 1981. These protections permitted the credit to flow through to customers as a reduction in their utility rates over the life of the asset rather than in the year realized by the utility. Without such protection, state utility commissions may require the credit to be flowed through to ratepayers immediately, reducing the effectiveness of the ITC as an investment incentive for utilities, defeating the credit's very purpose.

Further, I appreciate Treasury permitting the ITC to apply to the appropriate portion of an asset with a lengthy construction period. Many of the major construction projects undertaken by water utilities can takes several years to complete.

As a capital intensive industry - and the most capital intensive of any utility per dollar of revenue collected per customer - we also favor the President's proposal to modify the alternative minimum tax (AMT) depreciation method. With the large capital investment made or faced by our companies, many of them will be subject to AMT taxation for the first time. Designating depreciation as a preference item under the AMT acts as a disincentive to private investments in infrastructure.

In his AMT reforms, the President proposes eliminating the adjusted current earnings (ACE) depreciation computation and conforming AMT depreciation with regular tax depreciation. This will provide relief from the AMT for capital intensive businesses, allow for a single AMT depreciation computation and a single recovery period for computing tax depreciation.

SUGGESTIONS TO STRENGTHEN THE PRESIDENT'S PROPOSALS

Given the challenges facing our industry, notably the requirements of the Safe Drinking Water Act mentioned earlier, we - like many other industries - would suggest that the corporate tax rate not be increased from 34 to 36 percent. Indeed, since many of our systems operate in areas adjacent to municipal systems exempt from taxation, we can find ourselves at a competitive disadvantage. Cognizant of the need for shared sacrifices to deal with the existing deficit problem, we understand the rationale for the proposed rate increases.

Our industry, however, has a somewhat unique concern regarding the proposed top corporate tax rate of 36 percent on income over $10 million. Many of our member companies operate in more than one state, but file a consolidated return through a holding company. For example, my company, United Water Resources, files a consolidated return that includes Hackensack Water Company in New Jersey and Spring Valley Water Company in New York.

State utility regulators require us to operate as separate companies in each state. Although a holding company may have consolidated income far above $10 million, its subsidiaries may have income less than $10 million. In such a scenario, some state public utility commissions may only allow the subsidiary to recover the tax at the 34 percent rate even though it is paying a marginal rate of 36 percent on a consolidated return.

This treatment has several dilatory effects. In the short-run, our shareholders will pay the difference between the tax assessed and the tax recovered. This merely makes equity investments in our companies less attractive, thus making it more difficult to attract capital. In the long-run, our customers will suffer from the deferral or delay of other needed infrastructure investments, a result directly counter to the goals of the President's proposal.

This treatment will also act as a disincentive for the acquisition of small, poorly run water systems unable to comply with the Safe Drinking Water Act. We are under tremendous pressure from state regulators to acquire such systems and generally seek to be responsive, particularly when these acquisitions make business sense. Many of these acquisitions will not make sense if the actual tax liability cannot be recovered.

Finally, we urge the Committee to include in legislation encompassing the President's proposal a provision restoring the historical exclusion from gross income of contributions in aid of construction (CIAC) to a water or wastewater utility. The NAWC has been in contact with members of this Committee on numerous occasions concerning this issue. So I will summarize our concerns by stating that including CIAC in gross income merely subjects utility capital to tax - a tax that must be collected from our customers. This causes us to lose business, increases the price of new housing by as much as $2000 a unit and leads to the creation of poorly run water systems.

Making utility extensions from investor-owned utilities more expensive only aggravates the nation's infrastructure and water quality problems.

Just last month, Congressman Bob Matsui introduced H.R. 846, revenue neutral legislation that will restore the historical exclusion of water and wastewater CIAC from gross income. So far, he has been joined in this effort by several other members of this Committee, including Representatives Jacobs, Archer, Coyne, Kopetski, Herger, Kennelly and Thomas. Given the support for this non-controversial legislation by other Members of Congress as well, I hope you will include it in the President's package when you meet to consider it.

CONCLUSION

Mr. Chairman, let me conclude by quoting the words of President Clinton, "If we work hard and if we work together, if we rededicate ourselves to creating jobs, to rewarding work, to strengthening our families, to reinventing our government, we can lift our country's fortunes again". The NAWC is ready to work with you and the President to realize this crucial goal.

I am grateful for this opportunity to testify before you today and am happy to answer any questions you may have.

Mr. HOAGLAND. Thank you, Mr. Correll.

Mr. Holder, I think all of us are intrigued by the argument that the three of you are making from the aluminum industry about the extent to which electricity is a feedstock. How would you distinguish this kind of use of electricity from other kinds of use of electricity, and where would you draw the line? I mean, is there a realistic place to draw the line? Are there realistic definitions that would not open this sort of an exception to a floodgate of other exceptions?

Mr. HOLDER. I would first like to answer, but then call on my colleagues, if that is permissible, Mr. Chairman, to add any comments that they have.

As I believe all of us have said, it is defined as a nonfuel use in the production of primary aluminum, and it is not used for heating as a catalyst in the process. It is an electrochemical process in which electricity happens to be one of the three components.

Our industry is prepared to pay an energy tax where electricity is used in the fabrication of aluminum, which is where it is used in a more normal heating process and not as a catalyst.

Does anyone want to add something to that?

Mr. WILCOX. Yes, I would like to add two things.

The question on how do you distinguish aluminum reduction from other processes to me—you have granted there are feedstock exemptions for other things like coke in steel and petroleum in plastics. I can't distinguish electricity in aluminum from those things because we add electricity to that, just as you add petroleum to produce plastics. So that way it is not distinguishable.

Mr. HOAGLAND. I am aware of those. I notice that Mr. Boyle in his statement on page 2 talks about petroleum, coal used to make coke, natural gas used to make fertilizer, and Mr. Boyle indicates that petroleum is exempt, to make plastics is exempt, coke is exempt, natural gas maybe. Now, has that exemption been granted by someone? Has Treasury indicated that?

Mr. BOYLE. Yes. It is my understanding that that is true, and that is as a feedstock, nonfuel use.

Mr. HOAGLAND. Now, has that decision been made, do you know, Mr. Wilcox? Has that decision been made in connection with the President's proposal?

Mr. WILCOX. My understanding of the situation is there was that 84-page summary of the administration's proposal or something that came out, and those were specifically listed.

The problem with aluminum was it wasn't mentioned at all. So, at this stage, we don't know whether we are in that camp or not in that camp. We just want to make sure we are in with those guys.

The other point I want to make in terms of how do you distinguish aluminum from other things is it is very easily distinguishable because the use of electricity to make aluminum is different than almost any other use for two reasons. First of all, it is an electrolytic process, and there are only a handful of electrolytical processes that I know of. I think chlor-alkali uses it and titanium, but I don't really know of any others.

The other way to distinguish it, even from those uses, are just because of the degree of energy intensity. I am not aware of any

energy, any industry at all where electricity is such an important part of your total use.

If you want to draw a line, you can draw the line and put aluminum in that category without opening the door to other industries.

Mr. BOYLE. One thing about our application in the electrochemical reduction of alumina to aluminum is it is a direct current application and alternating current. We bring in alternating current from our powerplant, convert it within our plant to dc power, which goes directly into the process as this feedstock for the production of aluminum, and it is separately monitored and clearly listed on meters as to where that energy goes.

As Mr. Holder said, in other parts of the plant, the ac power goes to heat metal and do other things, other than go into the electrochemical process.

Mr. HOLDER. I believe there is also, Mr. Chairman, a precedent for this, as I had mentioned in my testimony, and I hate to be repetitive, but the EEC has recognized this for their aluminum industry and are granting an exclusion on that basis on the energy-intensive materials.

Mr. HOAGLAND. Yes, I saw that in there.

Mr. HOLDER. I think the competitiveness issue is important, and I am sure the committee is considering that.

Mr. HOAGLAND. Now, I am told by Mr. McDermott that, Mr. Wilcox, your plant is located near your power supply?

Mr. WILCOX. Yes, the Northwest and Washington State is really the aluminum capital of the world, and it is there because the Federal Government built the Bonneville Power, the system's dams on the Columbia, and, originally, there wasn't market for that power. So they encouraged the electrointensive industries to locate in the Northwest.

Mr. HOAGLAND. So you are located near the river, right near your power supply?

Mr. WILCOX. Yes. We originally had a direct connection to the dam that was built. The dam was built. There wasn't a demand for it. So the Government encouraged the plant to be built next to the dam to use the power that it produced.

Mr. HOAGLAND. And all of your raw materials then are brought in from elsewhere in the country?

Mr. WILCOX. Alumina is the principal raw material, and that comes in principally from Australia.

Mr. HOAGLAND. So, obviously, power is a key component.

I think you indicated, Mr. Holder, that 50 percent of your costs are electricity, is that right, in the manufacturing process?

Mr. WILCOX. No, that is our cost, and that is partly because of the nature of our operation. We are somewhat unusual.

Mr. BOYLE. It is more like a third in our case.

Mr. HOLDER. It is about the same with ours, about a third.

Mr. HOAGLAND. Has the industry applied to Treasury for an exemption?

Mr. HOLDER. We are talking with the Treasury about this, yes.

If I might just take one more minute of the committee's time to illustrate how competitive this situation is, my company is building a plant about 250 miles from the Mongolian border in Siberia, and

we are building this plant. It is not Reynolds' investment from a capital standpoint, but our technology is being used.

The Russians, several decades back, recognizing the strategic importance of aluminum, built hydroelectric dams on several rivers in Siberia at locations that we didn't even know existed. They put next to these hydroelectric dams aluminum smelters. These hydroelectric systems or the generating plant is not tied into a grid. So, if that electricity doesn't go to that smelter, you might as well run it in the ground.

So, when the cold war ended, about 35 percent of their uses for aluminum disappeared, and we all know the problems, and we have great empathy for the problems they have in their domestic economy today.

So these smelters are shipping metal into the world market to raise hard currency now because it is really a matter of survival. These towns located in places like where we are building this plant to make aluminum foil, to help them use the aluminum to improve their food distribution system.

But these smelters are very dependent on the operation to continue to provide some sorts of income for their people, but it has occurred at a time when the recession started and compounded the problem that exists in the U.S. aluminum industry today.

So we are not only concerned about where we stand versus other materials in this country, which is a very valid thing to look at, but we are also concerned about where we stand in the world or global business today in our industry, and we are being threatened from every standpoint, either by increased regulations—and all of us want to be responsible environmental citizens and are working to do that, but there are lots of pressures on us, including this proposed bill.

Mr. HOAGLAND. Thank you, Mr. Holder.

My time is up. Let the record reflect that I am turning the gavel over to our colleague, Mr. McDermott.

Mr. MCDERMOTT [presiding]. Mr. Jacobs.

Mr. JACOBS. Mr. Correll, you went over contributions in aid of construction rather briefly, and there are new members of the committee. Would you care to say for the record a little more completely how that phenomenon takes place, that we have a new building project and they need water supplies? Tell us about that.

Mr. CORRELL. Thank you.

The basic core business of NAWC's members is to provide water service. As a regulated water utility, our customers are protected by the regulation provided by the various State utility commissions. Indeed, we are a regulated monopoly, and our existing customers don't have any choice of where to go.

But in some areas where our investor-owned systems are adjacent to municipal nontaxpaying systems or in more rural areas where there is just a lot of open land, indeed, developers or new customers have a choice of where they would decide to put their homes and what water system they would hook up to.

When water systems or developers choose to go to a municipality, they forgo paying taxes to the Federal Government on the revenues and the income of the water business, and they also do not pay any

tax on the contribution that a municipality would also require to hook up the new system.

Another alternative is that they could form their own, what we call in our industry, developer-owned systems, where they would dig their own well and put in their own infrastructure. This leads ultimately to a proliferation of undercapitalized and not well-managed smaller water systems. This type of water system and the proliferation of it really just gives a black eye to our industry.

In our case, the contribution described above was considered to be income to all of our member companies under the 1986 Tax Act. As a result, to prevent cross-subsidies from all of our other existing customers, we were required to gross up the amount of the tax that we would require from a developer. That has created situations where developers have formed systems all around the perimeter of existing investor-owned systems to avoid paying the tax and resulted in the investor-owned companies not being able to grow.

It has also driven some future, what would have been, potential customers to municipal systems where they could also avoid the tax. So it has put us at a competitive disadvantage, a further competitive disadvantage, and it has also led to the creation of many of these smaller, undercapitalized developer systems, which I might add the EPA and State regulators are looking to reduce.

There are some 60,000 water systems in the country, some 22,000 that are investor-owned, probably 98 percent of them which are small, very small systems, which ultimately will not be able to meet the requirements of the Safe Drinking Water Act, and we are being encouraged to acquire and consolidate these. So continued taxation of the CIAC is in direct conflict to that goal.

Mr. JACOBS. I thank you. I think that enriches the record quite a bit. Thank you very much.

Mr. CORRELL. Thank you.

Mr. JACOBS. I yield back my time.

Mr. MCDERMOTT. Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman.

I appreciate the testimony of all the panel members. I have a couple of questions, mainly centered on the aluminum industry.

Number one, Mr. Holder, what you talked about building in Russia, how would you characterize the environmental systems of foreign aluminum plants compared to what our laws and what you may do in addition to our laws?

Mr. HOLDER. It varies a great deal around the world. Some countries in Europe have very rigid standards, just as we do here.

I talked earlier about the CIS nations, and I don't intend to pick on them. In their case, their environmental restrictions or environmental laws today are not nearly as strict as ours, and several of their smelters have severe problems with pollution.

I believe I can speak accurately when I saw that they are concerned about those environmental conditions and over time will take care of them, but their assessment of the priorities today, survival is number one.

Mr. KOPETSKI. There is another way of looking at this in terms of what feedstock means. It is sort of the same as in the steel industry. They take coal and they mix it, and, of course, they heat it in that, and then you produce coke which is necessary for steel.

For plastics, they take petroleum and mix it and cook it in all other kinds of things, and then you end up with plastic. So it is not running a motor. It is not heating a facility. It is actually a chemical process.

So, if you could take a can of energy and throw it in a pot with some alumina and kind of stir it up, you would end up with aluminum. Is that sort of the concept we are getting at here in terms of feedstock?

Mr. WILCOX. That is exactly right.

Mr. MCDERMOTT. If the gentleman will yield, it sounds like you have been trained in a soft science.

Mr. KOPETSKI. Very soft, Mr. Chairman. Very soft. [Laughter.]

So what you are asking for is equity of treatment here with the natural gas industries as well?

Mr. HOLDER. That is exactly right.

Mr. WILCOX. That is correct.

Mr. KOPETSKI. Is it generally recognized by scientists that electricity is a feedstock for making aluminum?

Mr. BOYLE. A lot of years ago, there was a scientist whose name was Faraday, and he basically structured the premise that demonstrated clearly that electrical energy went into the application for producing the metal aluminum from its oxide, and it was clearly defined a lot of years ago, and the process was basically developed about 110 years ago. As I said in my testimony, we haven't found another way to do it.

Mr. KOPETSKI. So we are not looking at something that is a new theory to avoid a tax?

Mr. BOYLE. No, it isn't.

Mr. KOPETSKI. Let me ask you this. I have a couple more questions. I know that in our home State of Oregon and the Northwest because we are tied into the BPA system that we are looking at a 20- to 25-percent increase in our electrical rates because of the drought and the Endangered Species Act with fish and timber, plus closing a nuclear powerplant.

So, when you talk about this percentage of increase, Mr. Wilcox, is this over and above that increase?

Mr. WILCOX. That is absolutely correct.

Mr. KOPETSKI. And this increase of 20 to 25 percent will occur this coming year?

Mr. WILCOX. October 1. That is correct.

Mr. KOPETSKI. October 1.

So would some sort of reduction in the treatment of hydro for the Northwest in that rate alone be enough to save your smelters or the Northwest smelters?

Mr. WILCOX. No, it would not.

Mr. KOPETSKI. Let me ask you about S corporations and C corporations. Is it a realistic option for you to change over to a C corporation? We notice in the President's package that the capital gains provision excludes S corps.

Mr. WILCOX. Yes, we could change over by filing a form.

Mr. KOPETSKI. Why wouldn't you or why would you?

Mr. WILCOX. You might. That is always an option. But there are disadvantages: If you ever have to dispose of the asset, and it basically would result in double taxation as opposed to taxation at just

one level. But that is definitely an option. For a 3½ percent surtax, it would be an option we would look at very carefully.

Mr. KOPETSKI. So there is a competitive advantage for you to be an S corporation?

Mr. WILCOX. Yes, sir.

Mr. KOPETSKI. In terms of the millionaire tax itself, are you opposed to taxing individual millionaires?

Mr. WILCOX. Oh, absolutely not.

Mr. KOPETSKI. Are you opposed to the corporate rate increase, assuming we could make some adjustments on the hydro, Btu, and the feedstock issue?

Mr. WILCOX. No.

Mr. KOPETSKI. Are you supportive of that corporate increase?

Mr. WILCOX. Yes; I am.

Mr. KOPETSKI. Thank you.

Thank you very much, Mr. Chairman.

Mr. MCDERMOTT. Thank you.

Let me ask a couple of questions because some people look at this Btu tax as having been a way to both raise revenue and also bring about conservation; that it has an environmental impact that, if you raise the cost, you will change consumption patterns.

Some would say that, perhaps, by raising the cost on electricity, that would force you to be more conservative in your use. What have you done about conservation in the aluminum plants in the Northwest or in the country, for that matter?

Mr. BOYLE. Conservation has been generally addressed by the industry since the creation of the reduction process because electrical energy has always been very expensive.

We have done a great deal. There has been some 22-percent reduction in the use of electrical energy in the past years.

Mr. MCDERMOTT. From what period are you saying 22 percent? Over the last 100 years or over the last 5 years?

Mr. BOYLE. No, in the last 20 years, I would say.

Mr. HOLDER. Possibly even a shorter period; since the early eighties in our company, reduced by that amount.

Mr. BOYLE. This has also been driven by certain regulations environmentally that we all meet and live by in our everyday operations. So there has been a tremendous effort made.

Overall, we have gone about as far as we can go with the technology as it is now structured, and, as I said, right now that technology is the only known practical technology that we can use. There have been tremendous inroads made in conservation of energy.

Mr. HOLDER. Plus, Mr. McDermott, we encourage recycling of aluminum. About a third of the supply of aluminum today in North America comes from recycled metal. As I believe I said in my testimony, we are up to 68-percent recycling rate on aluminum beverage cans. You can look at that package, in a sense, as an energy bank because we are able to turn that around. It is a closed-loop system.

It is to the industry's best interest to use as much recycled metal as we can, but we have certain applications, like aircraft, like building and construction, which are long-life applications of aluminum and not things that necessarily are recycled every 90 days.

So that, there will always be a place, technically, for primary metal in the industry, but we will always want to continue to recycle because it does save 95 percent of the energy required.

Mr. McDermott. How about your conservation efforts, Mr. Wilcox?

Mr. Wilcox. Because electricity is such an important part of your cost, you have to squeeze every last kilowatt hour out of your production.

So, when we talk about electricity being a feedstock, on the flip side of that is you need to add 3 electrons to each atom of aluminum to produce aluminum. So there is a physical limit below which you cannot become more efficient.

As a practical matter, that physical limit is 5½ to 6 kilowatt hours per pound. It is about the most efficient smelter in the world today, and most good smelters, including ours, are running in the 7-kilowatt-hour range. So there is not that much room to squeeze, and to squeeze that additional amount, you basically have to rebuild a brandnew plant.

Mr. McDermott. That sounds like 14 percent. Another penny a pound? It is not worth rebuilding your pipelines for 14 percent?

Mr. Wilcox. To rebuild a plant would cost you 25 cents a pound.

Mr. McDermott. So, really, you have reached the level, unless you simply changed the process altogether?

Mr. Wilcox. Exactly right.

Mr. McDermott. Tell me for my own information and for the record the percent of your production of aluminum that is electrical cost and the percent that is the cost to bauxite ore delivered to the dock.

Mr. Holder. In any company's position in the industry, about a third is electricity.

Mr. McDermott. And two-thirds is the cost of ore?

Mr. Holder. Bauxite, as well as the carbon and other materials that go into the production and the process.

Mr. Boyle. The alumina which is generated from the bauxite, more than likely, makes up about 20 to 25 percent of the other costs.

Mr. McDermott. Even shipping it all the way from Australia?

Mr. Boyle. Not all plants in the United States receive alumina from offshore. My company imports bauxite from South America and converts the bauxite to aluminum oxide in Louisiana, then moves it up the Mississippi and the Ohio River system to the smelter that we have in the Ohio Valley. So we bring in our own bauxite, and I know that Reynolds does.

Mr. Holder. We do a combination of both. We have operations in Australia, as well as a reduction or an alumina refinery in Texas, so that we bring bauxite into the Sherwood, TX plant and convert it to alumina there. In the case of our Northwest plants, we bring that in from Australia where we have an operation.

Mr. McDermott. And the electricity is added in which process?

Mr. Boyle. In the smelting process.

Mr. Holder. In the smelting, taking the alumina and converting it to aluminum.

Mr. Boyle. Alumina is aluminum oxide.

Mr. McDermott. Yes.

Mr. BOYLE. And you need the electrical energy to disassociate the oxygen radical from the aluminum.

Mr. MCDERMOTT. One other question I want to ask about, and that is more important, I suppose, to Mr. Wilcox and Mr. Holder. Bonneville Power Administration is already going to increase your rates for other reasons. Could you, for the record, talk about those costs and what you anticipate in increased rates?

Mr. WILCOX. Bonneville initially proposed an 11.6-percent increase effective October 1 of this year. Because of the terrible drought in the Northwest, Bonneville has not had the water they need. They had to buy a lot of replacement power. So they are looking at an increase this year of over 20 percent to go to ensure that they can repay the Federal investment in the Northwest power system, to cover their purchased power expenses, to cover their fish and wildlife expenditures, and restoring endangered salmon runs, and for conservation programs. As you know, we have one of the most aggressive conservation programs in the world.

Mr. MCDERMOTT. The cost then of this bill on top of that, if it is a 20-percent increase already for just conservation and for fish and wildlife and those problems, how much more is it beyond that?

Mr. WILCOX. Another 12 percent.

Mr. MCDERMOTT. So we are really looking at a 32-percent increase in the next year.

Mr. BOYLE. Mr. Chairman, if I might, I produce aluminum but not with hydroelectric power. I produce aluminum in the Ohio Valley from basically local coal. The power generation station that produces electrical energy for my smelter is a dedicated or a captive plant where I pay all of the associated costs. The costs for the coal, maintenance, capital, production, and taxes.

Mr. MCDERMOTT. Is this your own plant or do you——

Mr. BOYLE. It is a plant that was partially owned by my company originally but is now owned by a utility. But under the long term contract it is dedicated to us and we pay for all of the costs; costs-plus. The clean air amendments in 1990 will increase my power costs from that facility upward to 40 percent between now and the year 2000. So I am confronted with that. I am confronted with the Russian imports of primary metal that are coming into the Western markets. Over and above that is the $15 million a year that I see imposed on me by this new tax.

Mr. MCDERMOTT. We want to thank all of you for coming and giving us testimony. It is important for us to know what is happening to you. Thank you very much.

Mr. BOYLE. Thank you.

Mr. HOLDER. Thank you for the opportunity of speaking.

Mr. MCDERMOTT. This ends the hearing.

[Whereupon, at 3:45 p.m., the committee was adjourned to reconvene at 10 a.m., Thursday, April 1, 1993.]

PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

THURSDAY, APRIL 1, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 10:10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. I am going to ask our guests to find seats.

Today, we conclude our series of full committee hearings on President Clinton's economic and deficit reduction plan. In today's hearings, we will receive testimony from our colleague, Nydia Velázquez, of New York. In addition, we will hear from several distinguished government officials, including the chairwoman of the Missouri House Ways and Means Committee, Karen McCarthy, Mayor Acevedo of the city of San Juan, Ambassador Richard L. Bernal of Jamaica, and the former Resident Commissioner of Puerto Rico, Antonio Colorado.

We will also hear from several business associations and corporations. Many witnesses today will comment on the tax provisions affecting multinational corporations included in the economic package.

As we receive your testimony, we request that witnesses be prepared to offer revenue-raising alternatives for any modifications suggested to the existing package that would lose revenue.

Does any member have any statement to make?

Mr. RANGEL. Mr. Chairman, were you implying in your opening statement, if the President of the United States alleges that he can save $7 billion by changing the tax provisions affecting the Commonwealth of Puerto Rico, and we ignored it, that we in the Congress would have to suggest where $7 billion would be raised?

Chairman ROSTENKOWSKI. That has been the custom of this committee.

Mr. RANGEL. That is when the Chairman has set the mark, not when the President has.

Chairman ROSTENKOWSKI. Well, the President is making recommendations that this committee is going to have to consider, and I think that we have, as a party, agreed that we are going to try to endorse his program.

Mr. RANGEL. My only point, Mr. Chairman, is that the President has yet to present this to us and there is ample time, I would think

for him to present something to us that could avoid a confrontation or the need for us to have to raise this type of money.

Thank you.

Chairman ROSTENKOWSKI. We welcome our colleague, Congresswoman Velázquez, to the committee. Ms. Velázquez, if you would begin, please.

STATEMENT OF THE HON. NYDIA M. VELÁZQUEZ, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Ms. VELÁZQUEZ. Good morning, Mr. Chairman and members of the Committee on Ways and Means.

I appreciate the opportunity to testify before you on proposed changes to section 936 of the Internal Revenue Code and the effects of those changes on the Commonwealth of Puerto Rico, a part of the United States.

Mr. Chairman, as a native of Puerto Rico, I can assure you that any effort to repeal or drastically amend section 936 will have catastrophic consequences for Puerto Rico's fragile economy. An economy with a per capita income of $6,400, one-third the U.S. average and an unemployment rate of 18 percent.

The incentives that are offered to United States businesses under section 936 were first established in 1921 to attract American companies to establish their operations in the Philippines and nonincorporated territories. Throughout the years, Puerto Rico and the insular areas benefited from the creation of this economic program as a way to attract much needed capital investment to generate jobs and develop their economies.

As we all know, economic development is a delicate process involving many components, not the least of which is incentives that attract investment in productive enterprises. The continued presence of United States corporations creating new jobs in Puerto Rico is critical to the island's economic stability and growth. These companies are also critical to the Commonwealth's banking industry, accounting for approximately 30 percent of bank deposits, which provide low-cost funds to promote the island's economic growth.

I share the concerns of many, including our new President, over the skyrocketing price increases and the disproportionate profits of the pharmaceutical sector, but this issue must be separately addressed and not in the context of section 936, penalizing job creating investments will damage the Puerto Rican and American economies and will cause severe social dislocation in Puerto Rico and in Puerto Rican communities in the United States.

Mr. Chairman, let me remind my colleagues that these are not foreign jobs. Puerto Ricans born in Puerto Rico are U.S. citizens at birth. The loss of these jobs on the island will cause these workers to search for employment in the United States of America.

Erosion of the island's employment base will increase the exodus of Puerto Ricans to the mainland. We all know that most Puerto Ricans in the United States reside in large metropolitan areas. The new wave of Puerto Ricans coming to the United States will be searching for jobs they are not likely to find and housing that at any level commands premium prices. In addition, there will be an

added burden to the already embattled health care services in our communities and the overcrowded classrooms.

Therefore, section 936 cannot be viewed in purely fiscal terms as a cost factor to the United States. Instead, section 936 must be seen for what it is, a vehicle for advancing the economic and social progress that serves the practical and strategic interests of all American citizens, including the people of Puerto Rico.

Mr. Chairman, as U.S. citizens, Puerto Ricans join all Americans in support of the administration's efforts to solve our Nation's problems, including the President's attempts to create jobs and reduce the Federal budget deficit. Puerto Ricans are prepared to respond to the call for shared sacrifice. Of course, equity requires that Puerto Rico's American citizens not be singled out to bear a disproportionate share of the Nation's burden.

The administration proposal was drafted in response to mainland considerations, not island ones. It did not consider at all the very important implications for the enduring fight in Puerto Rico over the three status options, Commonwealth, statehood, and independence. As a Member of Congress, we cannot leave Puerto Rico in this social and fiscal limbo. As I have pointed out, there is not clear Federal policy toward the Commonwealth of Puerto Rico.

Any changes to section 936 must satisfy the following three objectives of paramount importance: one, the continued economic development of Puerto Rico; two, the furtherance of economic development throughout the Caribbean Basin; and three, continued economic activity within the United States.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Are there any questions? Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

You have heard the Chairman state that the President needs to raise $7 billion. What is your response to that?

Ms. VELÁZQUEZ. Well, the response to that, Mr. Chairman, is that since the 1950's, Puerto Ricans have been coming to the mainland seeking jobs. If we implement any drastic changes to 936, that will force the corporations that are in Puerto Rico to leave Puerto Rico, and also I will advise you that right now in Puerto Rico there is so much fear in terms of the consequences of the NAFTA agreement, those Puerto Ricans will be coming to the mainland searching for jobs, and at the end either we create jobs in Puerto Rico, either we secure those jobs that are in Puerto Rico or we have to create those jobs for those Puerto Ricans who will be coming to this country, plus provide health care services, access to health care, bilingual education, housing, economic development.

Mr. RANGEL. I would assume that the President of the United States and the administration would have discussed such a drastic change in the tax law with the Government of Puerto Rico. To your knowledge, has this been discussed in order to determine what, if any, impact this would have on the economy of Puerto Rico?

Ms. VELÁZQUEZ. Well, it is my knowledge that the Governor of Puerto Rico, Pedro Rossello, and the Resident Commissioner of Puerto Rico has been lobbying, and I do know that the Governor of Puerto Rico made public statements presenting a position and his concerns of the impact that will have on the economy of Puerto Rico, if section 936 will be changed or modified.

Mr. RANGEL. And to your knowledge, has the President of the United States and the Secretary of the Treasury or anybody in the Clinton administration indicated either to the Governor or the Resident Commissioner that they are changing their proposal in any way?

Ms. VELÁZQUEZ. Not to my knowledge.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Are there any further questions?

Mr. HOUGHTON. Could I ask you a question? There isn't any question that anybody who is hit with an increase in tax is unhappy. It is not easy. We are in an economic dip at the moment. Clearly, things have to change for this country and volume is very important, particularly when you are taking a look at 18 percent unemployment.

I am not sure how I feel about this, personally. But you say this issue must be in terms of skyrocketing prices and disproportionate profits. This must be addressed separately, not in the context of section 936. And then you talk about Puerto Ricans being prepared to respond to the call for shared sacrifice. How? What would they do? What would you suggest? How do we somehow cut into this deficit that we are all worried about?

Ms. VELÁZQUEZ. Well, let first say that I do share my anger and my frustration of President Clinton in terms of the pharmaceutical industry in Puerto Rico. But I do believe that that discussion should take place within the health care reform context, not penalizing Puerto Ricans. Let me remind you that Puerto Rico is part of the United States and is an underdeveloped country, and the impact that this modification will have will be catastrophic.

Mr. HOUGHTON. I understand that, but how would you suggest that Puerto Rico share, as you say, in the sacrifice? Tell me?

Ms. VELÁZQUEZ. Well, let me just say that after me there will be common people from Puerto Rico who are more involved in this aspect and they will be able to present alternatives. I am here to remind, as a Member of Congress, that we have to give special consideration due to the fact that any modification of 936 should not be done in a political vacuum, because there is a unique relationship, a unique political relationship between Puerto Rico and the United States.

Mr. HOUGHTON. Thank you.

Chairman ROSTENKOWSKI. Are there any further questions? Mr. Reynolds.

Mr. REYNOLDS. I welcome your testimony before our committee. We had one of your distinguished colleagues in our class of freshmen who is the former Governor of Puerto Rico and now a freshman in this body, as you and I are, and he takes the opposite view of this. The question I have for you is I would like for you to elaborate just a little bit on the effect of loss of jobs and how this would really hurt the people of Puerto Rico, if in fact we were against your position on this.

Ms. VELÁZQUEZ. Well, the private sector in Puerto Rico have already made a statement that they will not have any other choice but to leave Puerto Rico, and that will increase the unemployment rate that right now is more than 17 percent in Puerto Rico. And I have to remind you that we don't know at this point the kind of

effect that the NAFTA agreement, once it is confirmed by this institution, will have into the economy of Puerto Rico.

Mr. REYNOLDS. Thank you so much.

Chairman ROSTENKOWSKI. Any further questions? If not, thank you very much.

Ms. VELÁZQUEZ. Thank you.

Chairman ROSTENKOWSKI. Ms. McCarthy. Welcome to the committee. If you are ready to begin your testimony, the committee is ready to take it.

STATEMENT OF HON. KAREN McCARTHY, VICE PRESIDENT, NATIONAL CONFERENCE OF STATE LEGISLATURES, AND CHAIR, HOUSE WAYS AND MEANS COMMITTEE, MISSOURI HOUSE OF REPRESENTATIVES

Ms. McCARTHY. Mr. Chairman, thank you.

Good morning. I am pleased to be with you. I am currently serving my 17th year in the Missouri House of Representatives. I have chaired the House Ways and Means Committee for the past decade.

I come to you today as the vice president of the National Conference of State Legislatures. We wish to present our concerns and thoughts about the impact of Federal tax policy on the States.

As you know, NCSL is a nonpartisan organization created to serve the legislators and the staffs of the Nation's States and territories. We are eager to work with both Congress and the administration to enact tax policy changes that provide for short- and long-term economic growth and the reduction of the Federal budget deficit.

However, we are also dedicated to preserving the State tax base and the autonomy of the States under our federal system, and want to ensure that State tax and budget decisions are made in the best interest of our citizens.

In short, we do applaud the Clinton administration's call for a new approach and a new direction in tax policy. We believe we must work together, examining the effects of each action carefully, so that our new direction is the right direction.

As States, we have every reason to be wary. The 1981 tax reform legislation had a devastating impact on State tax liability and revenues collected. In addition, excluding Medicaid and welfare programs, real per capita State aid was cut 15 percent, and aid to local governments was slashed 55 percent.

Significant tax changes at the Federal level could exacerbate an already tenuous fiscal picture in the States, Mr. Chairman. I am here today to ask you not to let that happen. Right now, a majority of our States have balanced budgets. While we must strive for the Federal Government to follow that example, we urge that the Federal budget not be balanced on the backs of the States.

We support the permanent extension of certain tax credits which have expired. We believe that the reinstatement of these tax credits will assist the President in keeping his pledge to increase the Federal investment in both human and physical capital.

My written testimony speaks in detail about those credits. They are the mortgage revenue bond program, the low-income housing tax credit, targeted job tax credits, the earned income tax credit and employer-provided educational assistance.

However, investment is not the only matter of concern to the States. Under the President's plan, $328 billion in new tax revenues would be generated. Because the proposal also contains $82 billion in tax incentives for the same period, I understand the net revenue increase would be $245 billion.

These revenue increases are heavily weighted to personal income tax and the plan also includes new sacrifices for the business community. All of these areas have the potential to affect State tax liability and revenues.

I would remind committee members who served in State legislatures that, over time, most States have conformed significant aspects of their State individual tax codes to the Federal Tax Code. The desire for simplicity and compliance overrode other consideration by the States.

But by automatically accepting these changes, our State tax policy and revenue flows have to much extent been placed at the mercy of Federal policymakers, and since conformity causes these certain Federal tax policy changes to flow through to the State level.

Our organization commends the President's support for reducing itemized deductions and phasing out exemptions. This action could cause revenues to increase in States, with the Federal tax liability or Federal taxable income as their starting point. The national conference has long opposed limiting deductions of State and local taxes, so we are pleased that the President did not propose additional limitations.

Some of the administration's proposals should improve State revenues. The administration's initiative on transfer pricing enforcement is a perfect example. Underreporting at the Federal level translates into revenue loss for the States, as well.

The much discussed Btu tax on the intrinsic energy value of fuels could be less onerous on the State tax base than other alternative revenue measures, such as the value added tax, if the tax is properly designed. But in the spirit of intergovernmental tax immunity and tax fairness, this tax should not apply to consumption of governments and should be collected in such a way that it is least onerous to the user.

Overall, the President's plan is respectful of the balance of Federal and State fiscal interests. We have a President who has come to us from the State perspective, as have many of you members of this committee. He is an individual well aware of the problems which Federal policy changes in the 1980's did create for the States. We are pleased that the President did not call for an increase in Federal excise taxes on tobacco products or alcohol beverages, nor did he propose a general consumption tax.

We are further encouraged that the proposed economic plan does not seek to accelerate payments by State and local governments of the medical payroll tax, nor does it prohibit State collection of source taxes. Each of these actions could have severely affected State revenue collections.

While we may not agree with every element of the President's proposed revenue increases, all of us know that revenues will be needed to solve the budget deficit problem. However, we strongly agree that additional spending cuts must accompany these revenue

increases. As we move ahead in the days to come, working together to reach that goal, we might keep in mind another of the valuable lessons we can take from history.

Most people are familiar with the famous nude ride of Lady Godiva through the city of Coventry in 1057. But I think few realize that the reason for that famous ride was a tax issue. She had continuously begged her husband to reduce the taxes on the citizens, until he became so exasperated he told her he would only do so if she rode naked through the marketplace. As history recounts, she did indeed and the taxes were reduced.

But the lesson from the story is that she managed to preserve her character and her husband's pride, by concealing most of her body with the long and copious tresses of her hair, and still managed to be the heroine of her subjects. We can learn from the resourcefulness of Lady Godiva.

The most difficult fiscal problems have proper solutions. Just as Lady Godiva, we must seek answers that preserve our character and integrity and never compromise the trust we have been given by those we serve.

On behalf of the National Conference of State Legislatures, thank you for this opportunity to share our concerns.

[The prepared statement follows:]

STATEMENT OF REPRESENTATIVE KAREN MCCARTHY ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES BEFORE THE U.S. HOUSE WAYS AND MEANS COMMITTEE REGARDING REVENUE PROVISIONS WITHIN THE ADMINISTRATION'S ECONOMIC PLAN APRIL 1, 1993

INTRODUCTION

Good Morning. Mr. Chairman, members of the committee, my name is Karen McCarthy. I am currently serving my 17th year in the Missouri House of Representatives, where I chair the House Ways and Means Committee. I am here today as Vice President of the National Conference of State Legislatures (NCSL) to present our concerns about the impact of federal tax policy on the states.

NCSL is a non-partisan organization that serves the legislators and staffs of the nation's states and territorial legislatures. We are eager to work with both Congress and the Administration to enact changes in tax policy that provide for short and long-term economic growth and that reduce the federal budget deficit. We also are dedicated to preserving the state tax base and the autonomy of states, under our federal system, and to make state tax and budget decisions in the interest of our citizens.

With the federal budget deficit estimated at $300 billion for fiscal year 1994, NCSL continues to believe that addressing the deficit must be a priority. It threatens the long-term strength of our economy and the fiscal health of state and local governments. While federal tax changes may be necessary to accomplish this goal, NCSL is concerned about the impact federal tax changes have on state tax bases and revenues. We have every reason to be wary. The 1981 tax reform legislation had a devastating impact on state tax liability and revenues collected. A similar impact could occur from almost any federal tax changes and could exacerbate an already tenuous fiscal picture in the states. In your attempts to reform the federal tax code and reduce the federal budget deficit, I urge you not to erode state tax bases nor balance your budget on states' backs.

IMPACT OF SHORT-TERM STIMULUS & LONG-TERM INVESTMENT ON STATES

According to the Administration, creation of the short-term stimulus package is to ensure that "recovery from the recession is strong and durable." Moreover, the long-term investment plan is designed to enhance "America's capacity to produce and provide more opportunities for current and future workers." In that vein, NCSL supports the President's proposal to permanently extend certain expired (as of July 1, 1992) tax credits that will increase investment in both human and physical capital.

MORTGAGE REVENUE BOND PROGRAM. This program assists home buyers with low or moderate incomes. The tax-exempt status of mortgage revenue bonds allows states to pay lower interest on the bonds and to offer mortgage financing to eligible homebuyers at less than market rates. NCSL believes the MRB program helps maintain demand for housing, thereby preserving jobs in real estate, construction and related industries.

LOW-INCOME HOUSING TAX CREDIT. This is an effective program that helps states address low-income housing problems. State housing agencies allocate the credit to investors in low-income and mixed-income housing. This credit remains the one significant incentive, in the tax code, that encourages private sector investment in the production or rehabilitation of low-income housing. Missouri supplements this program with a 10 percent state tax credit to low-income housing developers.

TARGETED JOBS TAX CREDIT. This tax credit is available to employers that hire individuals from nine targeted groups. These groups consist of individuals who are recipients of payments under means-tested transfer programs, economically disadvantaged, or disabled. NCSL believes that permanent extension of this program would provide an incentive to American businesses to continue to invest in human capital.

While NCSL has no official policy on the following two tax credits, state involvement should be noted:

EARNED INCOME TAX CREDIT. This program provides financial assistance to low-income working families with children through a refundable tax credit. Some states supplement this program with a state EITC program, thereby allowing additional assistance to low-income families.

EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE. Under the internal revenue code, certain educational benefits to state employees are tax-exempt. Since this tax credit expired, 44 states are now responsible for the collection of these taxes. This benefit is a valuable tool in providing employees with the opportunity to maintain and/or improve their present skills for their current position.

IMPACT OF REVENUE PROPOSALS ON STATES

The President's plan suggests that additional taxes must be imposed to reduce the federal deficit to one percent of GDP by 1998. The proposal would raise $328 billion in tax revenues over the period 1993 - 1998. It also contains $83 billion in tax incentives over the same period, for a net revenue increase of $245 billion. The revenue increases are heavily weighted to personal income tax changes principally affecting higher-income individuals, but also include hikes aimed at businesses and energy consumption. Again, each tax proposal has the potential to affect state tax liability and revenues.

PERSONAL/CORPORATE INCOME TAX CHANGES. Over time, most states have conformed significant aspects of their state individual and corporation income taxes to the federal code. Motivated in large part by desires for simplicity and compliance, federal conformity also has certain drawbacks. It places state tax policy and state revenue flows, to some extent, at the mercy of federal policy makers because the conformity causes certain federal tax policy changes to flow through to the state level.

Changes in federal income tax rates will have a direct revenue impact on many states, in particular, North Dakota, Rhode Island, and Vermont, which base the state income tax on federal tax liability. Therefore, a federal tax rate increase would increase state revenues in these states, while a rate decrease would cause revenues to fall. With regard to corporate income, forty-seven states begin the computation of state tax with federal tax income. These states could experience a revenue windfall due to an increase in the federal corporate tax. Except for a few states, such as my own, which will experience a decrease in revenues from allowing the deductibility of federal income taxes on the state tax return.

REDUCING ITEMIZED DEDUCTIONS/PHASING OUT EXEMPTIONS. The President's proposal extends these provisions through December 31, 1995. The proposal could cause revenues to increase in states with a federal tax liability or federal taxable income starting point. NCSL has long opposed limiting deductions of state and local taxes, and we are pleased that the President did not propose additional limitations.

REPEAL HEALTH INSURANCE WAGE BASE CAP. States, as an employer, would be required to pay additional taxes as a result of eliminating the dollar limit on wages and self-employment income subject to HI taxes for wages and income received after December 31, 1993. As states struggle to balance their budgets in a time of economic uncertainty, payment of additional taxes is a burden we should not have to bear.

SUPPLEMENTAL SECURITY INCOME FEE. NCSL is concerned about the Administration's proposal to charge states a user fee for administering state supplemental SSI benefits. Currently, all but nine states supplement SSI benefits with state benefits. An additional user fee will certainly lead to a freeze or reduction in state supplements. As you are well aware, federal SSI payments alone are insufficient to raise the incomes of recipients to the poverty line. The Congressional Budget Office has acknowledged that state supplements fill the gap. States that elected to have the federal government administer their supplement should not be penalized.

Transfer Pricing. According to the Administration, its initiative on transfer pricing enforcement should yield a substantial improvement in tax collections from taxpayers who use abusive transfer prices to shift profits beyond the United States taxing jurisdiction. Both the IRS and Treasury have acknowledged that the shifting of income through international transfer pricing is causing a significant drain on federal corporate income tax revenues. Estimates of the annual federal revenue loss from just the "inbound" side of the problem -- excessively high transfer prices on sales by foreign corporations to their U.S. subsidiaries -- could range from $10 to $30 billion. Under-reporting of federal U.S. source income directly translates into a revenue loss for state governments. If the federal government is losing $10 to $12 billion annually, as President Clinton suggested during the campaign, that means the states are losing an additional $2 to $2.5 billion.

Broad-Based Energy Tax. The Administration's plan includes a tax (BTU) on the intrinsic energy value of fuels. Until the details of this plan are disclosed, it is unclear how this tax may affect states. Future increases in state gas taxes could be hindered by the proposed BTU tax, which is estimated to increase gasoline prices by 5 percent. At the same time, a properly designed BTU tax could be less onerous on the state tax base than other alternative revenue measures, such as a value-added tax.

To the extent that it affects the price of gasoline, it should have some downward pressure on gas tax revenues. To the extent that it becomes a cost item for business, it could lower revenues from corporate income taxes. And, to the extent that it suppresses energy demand (one of its stated goals), it could lower severance taxes for energy producing states. Although NCSL does not have an official policy on energy taxes, I believe that the tax would diminish environmental damages, encourage energy conservation, and reduce dependence on foreign sources of energy.

In the spirit of intergovernmental tax immunity and tax fairness, this tax should not apply to consumption of governments nor non-profit organizations and it should be collected in such a way that it is least onerous to the consumer.

Motor Fuels Excise Taxes. NCSL supports the Administration's proposal to dedicate 2 cents per gallon tax on motor fuels to the highway trust fund and 1/2 cents per gallon on motor fuels to mass transit. States prefer dedication of all motor fuels taxes to the trust fund as soon as possible to ensure the solvency of the trust fund.

Impact of Deficit Reduction on the States

In a recent letter sent to congressional leadership, state and local governments "concluded that without immediate bold action to cut the deficit, control the growth in the national debt, and increase national savings and investments, the United States will continue to experience reductions in the rate of productivity, economic growth, real wages, and the standard of living of most Americans." The fiscal health of the states depends on sustained economic growth.

According to a recent report (*State Fiscal Outlook for 1993*) released by NCSL, states' fiscal conditions in December 1992 are better than a year ago, and somewhat better than they appeared to be at the beginning of fiscal year 1993. It is essential, however, that the economic recovery be sustained, if states are to recuperate from the severe revenue shortfall of the past several years. Most states report that revenue collections so far in fiscal year 1993 are at or above the level on which budgets were planned, but ten states and the District of Columbia face continuing revenue problems.

On the expenditure side, cost overruns for Medicaid are common, and K-12 education and corrections are running over budget in some states. If current trends continue, many states will have difficulty bringing their budgets into balance by the end of the fiscal year. Thirteen states have already reduced their fiscal year 1993 budgets to bring them into balance. As states conclude negotiations for their fiscal year 1994 budgets, programmatic cuts or tax increases will be necessary to keep budgets in balance unless the economy grows more rapidly than expected. If the economy stalls, we will face severe problems.

As chairwoman of Missouri's Ways and Means Committee, I am in the process of formulating a revenue generating proposal that would both make our tax structure less volatile from the federal income tax changes proposed and provide additional funding for K-12 and Medicaid cost overruns.

CONCLUSION

Overall, the President's plan is respectful of the balance of federal and state interests in the intergovernmental fiscal system. We are pleased that the President did not call for an increase in federal excise taxes on tobacco products, or alcoholic beverages, nor did he propose a general consumption tax. We are further encouraged that the proposed economic plan does not seek to accelerate payments by state and local governments of the Medicare payroll tax nor does it prohibit state collections of source taxes. Each of these taxes would severely affect state revenue collections.

We may not agree with every element of the President's proposed revenue increases, but we also have concluded that revenues will be needed to solve the budget deficit problem. However, we strongly agree that additional spending cuts must be enacted with revenue increases. These cuts should not, however, be made in programs that provide genuine investment, for instance in education, job training, and infrastructure. Regardless of the outcome, we support a balance of spending reductions to tax increases in order to reduce the deficit.

On behalf of the National Conference of State Legislatures, I thank you for this opportunity to share our concerns for your consideration. Again, let me emphasize that reducing and eventually eliminating the federal deficit is our most serious national domestic policy challenge. We look forward to working with you toward that goal. I would be happy to respond to any questions.

Chairman ROSTENKOWSKI. Thank you.

Do any members have questions?

Mr. Brewster.

Mr. BREWSTER. Thank you.

Karen, very good testimony. It is certainly good to see you again.

Ms. MCCARTHY. Thank you, Congressman.

Mr. BREWSTER. As a former member of NCSL, we welcome your testimony today.

I read with interest that you are certainly supportive of balancing the budget, making cuts, et cetera, but these cuts should not ever be made in programs that provide genuine investment for education, job training, and infrastructure. If you look at our budget picture, you get to wondering where cuts can be made. Are you available and ready to go on board in supporting cuts in entitlements?

Ms. MCCARTHY. Yes, Congressman, we are ready, willing, and available to work with you and members of the committee toward these cuts and to make the ones that we in the States can live with. We pledge that support to you.

Mr. BREWSTER. Thank you.

Ms. MCCARTHY. Thank you.

Chairman ROSTENKOWSKI. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Welcome, Representative McCarthy. It is a pleasure to see and welcome you. Representative McCarthy is from the State of Missouri—the show-me State.

There are a couple of things that I would like to mention. In your testimony, you said that all of us agree that revenues will have to be increased to solve the deficit problem. Well, all of us do not agree with that. There are several of us that think that one; a reduction in the regulations, that have been imposed upon the American people for the past 30 to 40 years, and two, removing the waste, fraud, and corruption that exists, would solve the deficit problem without raising taxes.

There is a little item, and this is my first opportunity to even mention it, since I have been on the Ways and Means Committee—in article X of the State of Missouri's Constitution that has been nicknamed the Hancock amendment. That amendment was designed to prohibit taxes from growing faster than people's ability to pay.

I think you will agree that it has put up a very big caution light to the State legislators.

One section, which is section 21, says, that if the State of Missouri passed a law requiring an additional expenditure of funds at the local level, the State had to provide the money.

As a State legislator, do you think a Federal law requiring the Federal Government to fund State programs the Federal Government requires would help prevent unnecessary programs?

Ms. MCCARTHY. Thank you, Congressman. It is a delight to be with a fellow Missourian.

As a fiscal chairman and member of the Missouri House, I would welcome such a provision. I think that many of my colleagues around the country would also. We would welcome the Federal Government continuing to hand over duties to us that we could

best carry out in the State, and we would embrace it more readily, if you sent along some of those Federal dollars to help us perform those.

Mr. HANCOCK. Would you agree that the amendment in Missouri has probably stopped a lot of ideas that sound good, but maybe were not as good as they sounded?

Ms. MCCARTHY. Yes, Congressman, absolutely.

Mr. HANCOCK. And that would be the ideal thing here at the Federal level, that some of these ideas that do not apply to Oregon does not apply to the State of Missouri. Yet, when we pass the laws up here, it does apply all the way across the board.

Let me just say it is a real pleasure to see you and to have you here. I would like to point out that when 1980, when that amendment was passed, that the bond rating of the State of Missouri has improved dramatically. I know that you have been part of it, and I thank you very much for that.

Ms. MCCARTHY. Thank you very much, Congressman.

Mr. HANCOCK. Thank you.

Chairman ROSTENKOWSKI. Thank you very much.

Are there any more questions?

[No response.]

Ms. MCCARTHY. Thank you very much. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Héctor Acevedo, mayor of San Juan, Puerto Rico; the Hon. Antonio Colorado, former Resident Commissioner of Puerto Rico.

Welcome to the committee. I am sure that some of you have testified here before. You know that we try to keep you within the framework of a 5-minute dissertation, so that we can have some room for questions. I want to caution you that we have a lot of witnesses today to interrogate. I am just hoping that if your statement is longer than 5 minutes, the statement will be included in its entirety in the record. However, if it is longer, we would like for you to summarize it within a framework of 5 minutes.

Mayor Acevedo, if you are ready to begin, the committee is ready to take your testimony. I would like for you each to identify yourselves for the record, so that the court reporter can record that.

Mayor Acevedo.

STATEMENT OF HON. HÉCTOR LUIS ACEVEDO, MAYOR, CITY OF SAN JUAN, P.R.

Mayor ACEVEDO. Good morning. I am Mayor Acevedo, mayor of San Juan, Puerto Rico.

I am joined today by the Mayors Association of Puerto Rico, represented here by Mayor Jose Aponte of Carolina; Angel O. Berrios of Caguas; Santos Ortiz from Cabo Rojo; William Cintron of Yauco; and Melanio Bobe of Hormigueros; and our executive director, Angel Castillo.

Mr. Chairman and members of the committee, thank you for affording me the opportunity to express my ideas and my concerns to the administration's proposal to change the nature of the economic incentives available to U.S. corporations doing business in Puerto Rico.

In economic terms, our unique relationship has permitted Puerto Rico to develop its economy to the level of half of that of the poorest State, becoming the 10th largest trading partner of the United States, accounting for over 200,000 jobs on the mainland.

President Clinton's proposal to bring economic health to the United States' economy by reducing the deficit, enhancing productivity and making the United States competitive in a global market has the support of Puerto Rico. We are willing to contribute and bear our fair share of the cost of the national program. However, as the poorest jurisdiction under the U.S. flag, Puerto Rico's contribution to the national effort should be fair and proportionate to its social and economic level.

President Clinton's proposal to substitute the income credit of section 936 of the code, by limiting income tax benefits to 65 percent of the compensation paid would greatly impact Puerto Rico's successful economic development program and eliminate thousands of jobs in the high-technology, highly-skilled and well-paid industries that have substituted the low-wage jobs that have been lost to foreign jurisdictions. Even a 100 percent wage credit would result in a loss for Puerto Rico.

In 1985, President Reagan also proposed a wage credit and, after careful consideration and reevaluation, the wage credit was viewed as a measure that would hurt, rather than help, the development of Puerto Rico.

I am submitting, Mr. Chairman, a table here that will illustrate what has happened in Puerto Rico in the last 10 years. In 1982, we had 71,000 jobs in the labor-intensive industries, and only 45,000 jobs in the high-technology industries. Today, in 1992, we have 60,000 jobs in the labor-intensive and 56,000 jobs in high-technology. We have substituted the losses in the labor-intensive industries with high-technology manufacturing, because that is the available market of jobs. That is why the wage credit is not a realistic option for the future in terms of attracting new jobs for Puerto Rico.

The proposal to impose taxes of $7 billion on income derived from Puerto Rico will not only play havoc with our economy, but will not be actually realized in the long run by the U.S. Treasury. This results in thousands of layoffs and increased unemployment, which today is 18 percent in Puerto Rico, because of mortgage foreclosures ensured by the Federal Government and the need for more employment benefits and a myriad of other costs will have to be borne by the Federal Government, if the economy is destabilized.

In reviewing the President's proposal, one must find the following facts: If you compare the contribution of any jurisdiction with Puerto Rico—and I am submitting a table to that respect—you will find that the person in Puerto Rico will contribute $1,944 in new taxes, and a person in the United States will contribute $906 per person. Is this fair? Is this proportionate?

Has anyone stopped to consider whether a proposal that doubles the per capita tax burden of citizens in Puerto Rico in comparison to the mainland is just and equitable?

We want jobs for our people, to protect the jobs we already have and create new ones for our own employees. We do not want our people to forcefully migrate or have to resort to welfare to pursue

a better life. I want my people to work in well-paying jobs. That is the President's program, and we cannot destroy with our left hand what we are trying to create with our right hand.

Our ability to pursue a better life is affected by many factors, the actions under consideration of this committee included. You have the authority and the experience in dealing with section 936 to raise the proportionate amount of Puerto Rico that we have calculated more closely to $1 to $7 billion, without taking the incentive to create jobs in the future for our island.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

TESTIMONY

THE HONORABLE HÉCTOR LUIS ACEVEDO
Mayor of San Juan, PR

Before the

Ways and Means Committee
U.S. House of Representatives

April 1st, 1993

Good Morning, Mr. Chairman and members of the Committee. Thank you for affording me the opportunity to express my ideas and raise my concerns to the Administration's proposal to change the nature of the economic incentives available to U.S. corporations doing business in Puerto Rico.

In economic terms, our unique relationship has permitted Puerto Rico to develop its economy to the level of half of that of the poorest state, becoming the tenth largest trading partner of the U.S., accounting for over 200,000 jobs on the mainland and and contributing significantly to U.S. foreign policy by sharing its technology and 936 funds with its Caribbean neighbors and, thus, assisting the U.S. in maintaining economic stability in the region.

President Clinton's proposal to bring economic health to the U.S. economy by reducing the deficit, enhancing productivity and making the U.S. competitive in a global market, has the support of 3.6 million American citizens of Puerto Rico who are willing to contribute and bear their fair share of the cost of the national program. However, as the poorest jurisdiction under the U.S. flag, Puerto Rico's contribution to the national effort should be fair and proportionate to its social and economic level.

As a Democrat, I share the President's view that the private sector is the engine of economic growth in America and that includes Puerto Rico. To do this, the President is proposing an investment package for the private sector based primarily on tax incentives.

Notwithstanding the non-applicability to Puerto Rico of the several tax incentives now proposed for the private sector, the Administration is proposing to change the essence of Puerto Rico's tax incentive program, which has created 300,000 jobs directly and indirectly. Section 936, as our tax incentives are commonly known, is not just a provision of the tax code — it is the backbone of our economy and the foundation of the economic relationship between Puerto Rico and the U.S.

President Clinton's proposal to substitute the income credit of Section 936 of the Code by limiting tax benefits to 65% of compensation paid, would greatly impact Puerto Rico's successful economic development program and eliminate thousands of jobs in the high-technology, highly-skilled and well-paid industries that have substituted the low wage jobs that have been lost to foreign jurisdictions. Even a 100% wage credit would result in the loss of approximately 20,00 direct jobs and another 40,000 indirect jobs. The latter jobs are the best paid on the Island and represent for Puerto Rico and its future the "Vision for America" President Clinton promotes.

In 1985, President Reagan also proposed a wage credit and, after careful consideration and reevaluation, the wage credit was viewed as a measure that would hurt rather than help the development of Puerto Rico. Therefore, the proposal was dropped.

The Administration's proposal would levy new taxes amounting to $7 billion over a five-year period on the 936 companies doing business in Puerto Rico. Such proposal, fashioned without consultation with the duly elected officials of Puerto Rico, would alter the long-established custom and tradition of not imposing taxes on income derived from sources in Puerto Rico. Puerto Rico and its citizens have foregone substantial taxation of such income throughout the years in order to develop an industrial base which has transformed the Island's economy and which now contributes 40% of its gross domestic product. Nevertheless, the fact remains that the income which is now proposed to be taxed, is wholly derived in Puerto Rico from our factories and produced by the American citizens of Puerto Rico.

The proposal to impose taxes of $7 billion on income derived from Puerto Rico will not only play havoc with our economy, but will not be

actually realized in the long run by the U.S. Treasury. The severe harm caused to the Island would result in thousands of layoffs, an increase in unemployment from the present 17%, a host of mortgage foreclosures insured by the federal government, the need for more unemployment benefits, and a myriad of other costs which would have to be borne by the federal government if the economy is destabilized.

In reviewing the President's proposal, one must necessarily take into consideration the level of social and economic activity in Puerto Rico in order to determine what a fair and just contribution by the Island would be to the present national effort. The Island continues to be densely populated with over 1,000 people per square mile and unemployment exceeding 17%. Its per capita income is less then one third of the mainland and less than half that of Mississippi.

Of the $246 billion in new taxes in the President's proposal, $7 billion would be imposed on Puerto Rico. In other words, 2.85% of the new taxes would come from Puerto Rico, whereas the Island has only 2.37% of the population of the U.S., 0.57% of its gross national product, 0.43% of the gross domestic product and 31.4% of the per capita income of the mainland.

In so being, the poorest jurisdiction under the American flag would pay $1,944 per person in new taxes, whereas the mainland population would pay only $960 per person. Is this fair? Is this proportionate? Has anybody stopped to consider whether a proposal that doubles the per capita tax burden of American citizens in Puerto Rico in comparison to the mainland, and which risks destabilizing its economy, is just and equitable?

As The Washington Post Editorial recently stated, the Administration's proposal is just "half of a Puerto Rican policy". The editorial continued to say: "... mainland political and policy reasons having nothing to do with the welfare of the island..." are behind the Administration's change. The Washington Post has asked, I am asking and I hope you, too, will ask: "But then what?"

If we were to compare and determine a fair and proportionate share for Puerto Rico's contribution to the national effort at this time, it would closer to $1 billion, not $7 billion. It is our obligation, as American citizens, to participate in the national effort, but in so doing, it is also necessary to

establish what is the just and equitable contribution of the Island. But one that does not deprive the Island of its principal tool for economic development, Section 936, and leave our modest manufacturing base subject to the uncertainties of NAFTA.

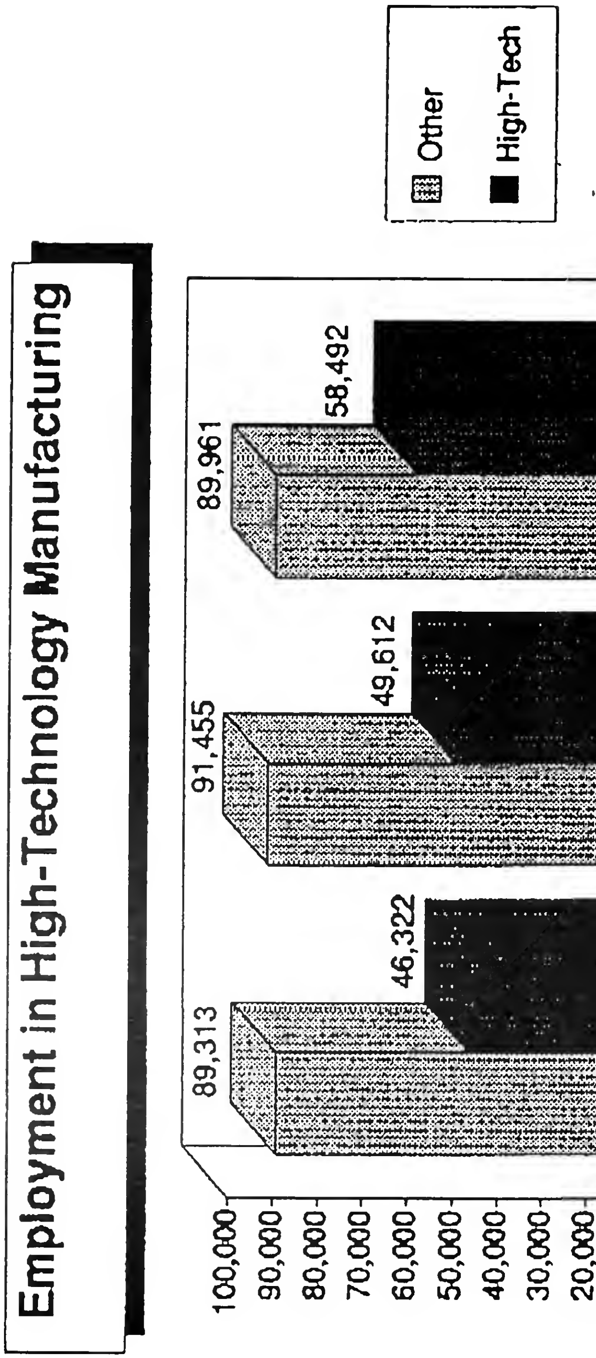
All Puerto Rico and its 3.6 million American citizens want is fair play. Our industrial development program creates permanent jobs at a cost in tax benefits of approximately $22,000, or $8,900 when you consider the direct and indirect jobs created. President Clinton's job stimulus package will cost approximately $50,000 per job, and many of them are of a temporary nature.

We want jobs for our people, protect the jobs we already have and create new ones for our unemployed. I do not want my people to forcefully migrate or have to resort to welfare to pursue a better life. I want my people to work in well-paying jobs. In this regard, I fully support President Clinton's goals. We need jobs, not hand-outs. Keep in mind that more than 62% of our families live under the poverty line.

Our ability to pursue a better life is affected by many factors, the actions and determinations of this committee included. You have the authority, responsibility and experience to provide guidance to the new Administration in order to avoid creating a greater degree of impoverishment among our people.

The President's "Vision of America" needs to include the 3.6 million American citizens of Puerto Rico. I am asking you for fairness for Puerto Rico in the execution of the President's program.

Thank you.


Employment in High-Technology Manufacturing
Other
High-Tech
100,000
90,000
80,000
70,000
60,000
50,000
40,000
30,000
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10,000
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46,322
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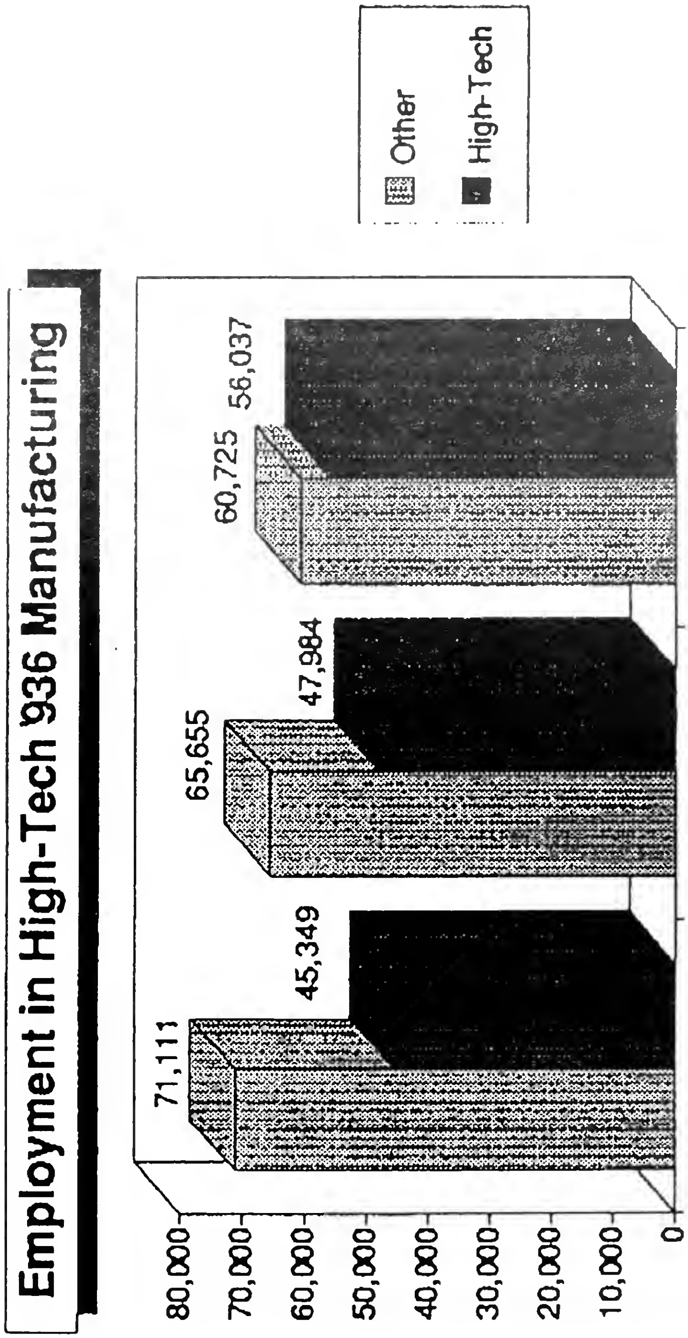
89,961
58,492
1982
1987
1992



Employment in High-Tech 936 Manufacturing
Other
High-Tech
80,000
70,000
60,000
50,000
40,000
30,000
20,000
10,000
0
71,111
45,349
65,655
47,984
60,725
56,037
1982
1987
1992

UNFAIRNESS OF PRESIDENT CLINTON'S PROPOSAL FOR PUERTO RICO

PUERTO RICO	UNITED STATES	%
New Taxes		
$7 billion (5 yrs.)	$246 billion	2.85%
Population		
3.6 million	256 million	1.37%
Gross Domestic Product		
$34 billion	$6 trillion	.57%
Gross National Product		
$23.6 billion	$5.5 trillion	.43%
Per Capita Income		
$6,750	$21,480	31.4%
New Taxes Per Person		
$1,944	$960	

A Fair Contribution by Puerto Rico Would Be:

A) .57% of $6 trillion GDP = $1.4 billion

B) .43% of $5.5 trillion GNP = $1.1 billion

C) 1.37% of population x $246 billion of new taxes = $3.370 billion; $3.370 billion x .31% of per capita = $1.045 billion

Chairman ROSTENKOWSKI. Thank you.
Mr. Colorado.

STATEMENT OF HON. ANTONIO J. COLORADO, WASHINGTON, DC, FORMER RESIDENT COMMISSIONER OF PUERTO RICO

Mr. COLORADO. Thank you, Mr. Chairman.

I am Antonio Colorado. Mr. Chairman and members of the Committee on Ways and Means, I appear before you on my own behalf, not on behalf of or in representation of any other person, organization or entity, to express my opinion in reference to the administration's proposal to limit the possession's tax credit.

For the last 8 years, I was responsible for overseeing section 936 issues. It is with great pleasure, but with extreme concern, that I return to this committee. I believe you will do justice to Puerto Rico, as you have done in many previous occasions.

I strongly oppose any wage credit proposals, because they would spell economic disaster for Puerto Rico, reducing considerably the capacity of the island to attract new investments and to collect future taxes. Our economy depends heavily on exports, the production of which is subject to all Federal laws and regulations.

Over the past 10 years, our economy has shifted significantly to high technology. Section 936 generates about 120,000 direct jobs and an estimated 180,000 indirect jobs, accounting for almost one-third of Puerto Rico's total employment.

The concept of a wage credit to replace section 936 is not new. A similar proposal was made by Treasury in 1984. After detailed discussions, the replacement of section 936 with a wage credit was rejected, because a wage credit simply would not be sufficient to foster the high-technology economy in Puerto Rico.

Today, such wage credit approach would have an even worse effect on Puerto Rico. Puerto Rico's average manufacturing wages are close to $6.50 per hour, while other countries around the world offer hourly wage rates of less than $1.50 per hour. We cannot compete for those jobs, when our costs of transportation, electricity, water and sewage, wages and fringes are, and will continue to be, much higher.

I recognize that changes are required in the U.S. tax policy, in order to reduce the deficit. Puerto Rico should be willing to shoulder its fair share of whatever burden is imposed on U.S. citizens according to what Puerto Rico receives and to what Puerto Rico can pay. Income realized from any activity in Puerto Rico is Puerto Rican source income. The Commonwealth has primary jurisdiction to tax this income before the United States or any foreign country.

If section 936 were modified as suggested by the administration, the United States would, in practice, be taxing the Puerto Rico source income of 936 companies, reducing considerably the taxing capacity of Puerto Rico. Puerto Rico would suffer the worst of two worlds: on the one hand, loss of businesses and new promotions, and, on the other, its taxes would be paid to another jurisdiction.

Puerto Rico contributes in many ways to the mainland's economy and well-being. It purchases approximately $11 billion from the mainland every year, generating an estimated 220,000 jobs in the continental United States. An additional $11 billion is repatriated as profits of mainland businesses in Puerto Rico, creating also ad-

ditional jobs. Because all merchandise products and materials are transported to and from Puerto Rico in U.S. bottoms, we end up paying for one-third of the U.S. merchant marine.

Puerto Ricans also pay taxes to the U.S. Treasury on their income from sources outside Puerto Rico, an amount which continues to increase. One of the most important ways in which we contribute is that as U.S. citizens. Our young men and women participate in the military and many have given their lives for their country.

A considerable reduction in Puerto Rico's economic growth would substantially affect all of our economic contributions to the mainland. The question with which we are presented today is essentially how much of the potential tax revenue that Puerto Rico could realize if it subjected the section 936 companies to additional Puerto Rican taxation should it share with the United States as a price for not destroying the island's economy. Obviously, $8 billion is not fair.

In my judgment, the issue should be considered from the standpoint of how much revenue Puerto Rico should be expected to contribute to the U.S. deficit reduction. Once that is established, I suggest that an adjustment to the allocation of intangibles be studied that could produce U.S. tax revenue, without abandoning the concept of an income-based possession tax credit.

Mr. Chairman, thank you very much.

[The prepared statement follows:]

TESTIMONY OF
ANTONIO J. COLORADO

PRESENTED BEFORE THE HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

APRIL 1, 1993

I. INTRODUCTION

Mr. Chairman and Members of the Committee, I appear before the Committee on Ways and Means today on my own behalf, not on behalf of or in representation of any other person, organization or entity, to express my opinion in reference to the Administration's proposal to limit the possessions tax credit. As you know, I have previously appeared before this Committee on several occasions in my prior capacities as Administrator of Puerto Rico's Economic Development Administration (Fomento), as Secretary of State of the Commonwealth of Puerto Rico, and as Resident Commissioner from Puerto Rico in the U.S. Congress under the Administration of then-Governor Rafael Hernandez-Colon. For eight years during his administration I was responsible for overseeing Section 936 issues. It is with great pleasure, but with extreme concern, that I return to the Ways and Means Committee. I am here because I believe you will do justice to Puerto Rico as you have done in so many previous occasions.

The Administration's proposal would limit the existing section 936 credit to 65 percent of the wages paid by a possessions corporation to its employees in Puerto Rico.

The response of the present Commonwealth government to the Administration's proposal has been confused. Inconsistent statements have been made by the Resident Commissioner Romero-Barcelo and by Puerto Rico's Secretary of State Corrada before this Committee. After having committed himself and his government to the defense of section 936, in a memorandum to President Clinton on March 24, 1993, Governor Rossello advocated the complete abandonment of the income-based possessions tax credit in lieu of a 123 percent wage credit and a 10 percent investment credit.

I strongly oppose the wage credit proposal of the Administration and of Governor Rossello because they would spell economic disaster for Puerto Rico and its 3.6 million United States citizens, reducing considerably the capacity of the island to attract new investments and to collect future taxes on Puerto Rican source corporate income. Puerto Rico, the poorest part of the United States should not be looked upon as a revenue source for the Federal government.

Great concern has been expressed about the high cost of medicines and other pharmaceutical products in the United States. Some of the companies that are established in Puerto Rico have been blamed for this. The way to deal with this perceived problem can not be to penalize the corporations only if they do business in Puerto Rico. Increasing taxation, therefore increasing costs, can not reduce pricing. This issue is apparently being addressed in the comprehensive health care review now under way under the leadership of Hilary Rodman Clinton, and that is where it should be taken care of.

II. HIGH TECHNOLOGY MANUFACTURING IS NOW THE BACKBONE OF PUERTO RICO'S ECONOMY

The United States citizens residing in Puerto Rico have a per capita income of $6,200, less than one-third of the average in the United States. Puerto Rico, an island with few natural resources, is over 1,000 miles from the United States mainland and has a

population density 60 percent greater than that of El Salvador, the most densely populated country in Latin America. The current unemployment rate in Puerto Rico is 18.1 percent, the highest in the last seven years.

Our economy depends heavily on exports, the production of which is subject to substantial federal regulation, including U.S. minimum wage laws, social security and unemployment taxes, the Jones Act, environmental, and occupational health and safety laws, among others. Manufacturing is the key to Puerto Rico's economic viability. In 1992, the $21 billion worth of products exported by Puerto Rico was equal to 61% percent of its entire gross domestic product. Most of those exports were from section 936 manufacturing companies.

Over the past 10 years Puerto Rico's economy has shifted significantly to high-technology manufacturing. There has been an increase of 10,688 high-technology section 936 manufacturing jobs in Puerto Rico, from 45,349 jobs in 1982 to 56,037 jobs in 1992. These high-tech manufacturing jobs are extremely important to Puerto Rico, since they are the best paying jobs, and consequently, they produce the most tax revenue to the Government of Puerto Rico and the highest multiplier effect for the economy of Puerto Rico. By comparison, the total number of low-tech section 936 manufacturing jobs in Puerto Rico has declined from 71,111 in 1982 to 60,725 in 1992, or a loss of 10,386 jobs.

Section 936 and its predecessor provisions have been the key to Puerto Rico's economic development. Section 936 generates about 120,000 direct jobs in Puerto Rico and an estimated 180,000 indirect jobs, accounting for almost one third of Puerto Rico's total employment. Today, hundreds of U.S. manufacturing corporations, ranging from computer and electrical equipment to heart pacemakers, have improved their international competitiveness by manufacturing in Puerto Rico using section 936. Section 936 corporations do pay Puerto Rico income taxes, as a matter of fact they pay a higher proportion (22.2%) of Puerto Rico's total income taxes than all corporations in the U.S. pay of U.S. income taxes (18.8%). To illustrate the enormous significance of the manufacturing sector to the overall economy of Puerto Rico, a 20 % reduction in Puerto Rico's manufacturing gross product would be the equivalent of eliminating all agriculture production together with all tourism activity in Puerto Rico.

Thus, Puerto Rico depends upon the income-based credit to preserve its economy, which, although the highest of the Caribbean, is by far, as stated before, the poorest part of the United States.

III. PUERTO RICO NEEDS AN INCOME-BASED CREDIT TO PROMOTE NEW HIGH-TECH JOBS

The concept of a wage credit to replace section 936 is not new. As many of you recall, a similar wage credit proposal was made by the Treasury Department in 1984 and 1985 during the formulation of what became the Tax Reform Act of 1986. After detailed discussions with the Treasury Department and the Congress, the replacement of section 936 with a wage credit was rejected for one basic reason: a wage credit simply would not be sufficient to foster the present high-tech economy in Puerto Rico. Today, such wage credit approach, rejected in 1986 by both the Administration and the Congress, would have an even worst effect on Puerto Rico than the one thought eight years ago.

Puerto Rico does not compete in today's worldwide economy for labor-intensive manufacturing projects. Its average manufacturing labor costs, which are of course subject to U.S. minimum wage laws, are high, close to $6.50 per hour. By contrast, Caribbean and Central American countries, Mexico, and other countries around the

world offer hourly wage rates of less than $1.50 per hour. Puerto Rico cannot reconfigure its economy to attract labor-intensive businesses, even with a wage credit, while its wages and other manufacturing costs continue to increase. As the U.S. Treasury Department came to recognize in 1985, a wage credit is simply the wrong incentive for our island's economy. Puerto Rico will continue to lose low-tech jobs to Asia, Central America, the Caribbean and Mexico. Furthermore, we can not compete for those jobs when our costs of transportation, electricity, water and sewage, wages and fringes, are and will also continue to be much higher.

If section 936 is to be modified, any wage credit approach must be rejected because it could never preserve the Puerto Rico economy at anywhere near its current level. It must be understood that after applying the wage credit the additional income of a 936 company would be fully taxable in the United States and partially taxed in Puerto Rico. This will make such additional income taxable at much higher rates than those on the mainland. With any of the proposed amendments we will not effectively attract new investments in high-tech projects, while the low-tech jobs will continue to leave to countries with lower wages. Puerto Rico needs an incentive to attract high-technology industry into Puerto Rico that provides the multiplier effect and enhances the island's tax base.

IV. INVESTMENT OF SECTION 936 FUNDS IS CRITICAL TO PUERTO RICO AND THE CARIBBEAN REGION

Section 936 funds deposited in Puerto Rico financial institutions permit lending at lower rates in Puerto Rico, which provides impetus for growth in all sectors of the economy, not just manufacturing, but also for infrastructure for education, health and commercial purposes. Thousands of Puerto Ricans could not afford their own homes without low interest financing with section 936 funds.

In 1986 Congress amended section 936 to permit the lending of section 936 funds in projects in Caribbean Basin countries which have signed tax information exchange agreements ("TIEAs") with the United States (i.e., "qualified countries"). As a result of efforts by the United States and Puerto Rico, section 936 funds have become a leading source of project funding in the Caribbean, greater than the World Bank or the Inter-American Development Bank.

Through March 1993, $956 million of investments were promoted with section 936 funds in 9 qualified countries. As a result, over 15,500 direct jobs are being created in 62 different projects, including telecommunications, agribusiness, food processing, infrastructure, manufacturing and tourism. Projects varied from large development projects to small regional projects financed by the Caribbean Partners for Progress, Ltd., with an average loan size of $600,000.

An improvement in the economic health of the Caribbean Basin directly benefits the United States. When investment in the region expands, imports increase and additional U.S. exports and jobs are created. The United States registered a 1990 trade surplus with the Caribbean Basin countries of over $2 billion. The importance of the economic health of the Caribbean was eloquently stated by President Clinton at the 1992 Miami Conference on the Caribbean: "Improved economic growth in the Caribbean Basin is in the direct interest of the United States. It helps create jobs and exports for the United States. It helps to promote the ideals of democracy, which are important for us not only in our own nation, but throughout this hemisphere. . . ."

Any change in section 936 that would shut down the investment of section 936 funds in the Caribbean would be a serious breach of faith with those Caribbean countries which have signed and ratified TIEAs with the United States. Similarly, the United States itself must honor the spirit of the TIEAs entered into by our Caribbean neighbors in good faith and continue its full support of the section 936 CBI program.

V. PUERTO RICO SHOULD NOT BE FORCED TO CONTRIBUTE A DISPROPORTIONATE AMOUNT RELATIVELY MUCH BIGGER THAN THE MAINLAND

I recognize that changes are required in U.S. tax policy in order to reduce the Federal deficit. Indeed, I commend President Clinton for taking a bold position of leadership that reflects responsible government. Even though not a state, Puerto Rico should be willing to shoulder its fair share of whatever burden is imposed on U.S. citizens according to what it receives and what it can pay.

I do not believe, however, that our fair share is over $8 billion for the next 5 years. Puerto Rico, as a Commonwealth, does not obtain the same benefits as do the 50 states from the Federal government in terms of food stamps, health care benefits and other welfare payments.

Puerto Rico enjoys fiscal autonomy and has its own separate system of taxation. Income realized from manufacturing or any other activities in Puerto Rico, whether earned by a U.S. corporation qualifying for the benefits of section 936, by a Puerto Rico corporation, or by any other type of corporation, is Puerto Rico source income. As a commonwealth, Puerto Rico has primary jurisdiction to tax this income -- before the United States or any foreign country. In other words, if section 936 were repealed and U.S. corporations presently doing business in Puerto Rico remained there (an unrealistic assumption), the United States would most probably not realize any tax revenue from such repeal because the Government of Puerto Rico would tax the Puerto Rico source income of those corporations, which tax would be available as a credit against any United States tax.

However, if section 936 were modified as suggested by the Administration, the United States would in practice be taxing the Puerto Rico source income of 936 companies. This would have the effect of reducing considerably the taxing capacity of Puerto Rico. Many section 936 manufacturing businesses will be forced to leave Puerto Rico, and certainly not many new businesses will be started in Puerto Rico. Once this occurs, Puerto Rico loses its source of jobs, its source of corporate tax revenues, the income taxes paid by the employees, and other jobs dependent upon the jobs which are lost (a reverse multiplier effect). In other words, Puerto Rico's economy experiences dramatic contraction and dislocation. Puerto Rico would suffer the worst of two worlds; on one hand loss of businesses and new promotions and on the other, its taxes would be paid to another jurisdiction.

Whether the United States will realize the full amount of tax that it anticipates if this dire scenario were to unfold is in my opinion highly doubtful. Just because businesses leave Puerto Rico does not mean they will relocate to the United States. Many other foreign jurisdictions provide highly attractive opportunities for manufacturing that are competitive with Puerto Rico today. Loss of Puerto Rico jobs to Singapore, Ireland or other foreign countries is not in the interest of the United States, and it is surely catastrophic for Puerto Rico and its residents. In addition, if NAFTA becomes a reality and 936 is mutilated many more low-tech and possibly some high-tech jobs will be lost by Puerto Rico to Mexico.

Puerto Rico contributes in many ways to the mainland's economy and well-being. Puerto Rico purchases approximately $11 billion from the mainland every year generating an estimated 220,000 jobs in continental United States. An additional $11 billion are repatriated as dividends and profits of U.S. businesses in Puerto Rico creating also additional jobs in the mainland. Because of all the merchandise, products and raw materials being transported to and from Puerto Rico, we end up paying for one third of the United States merchant marine. Being forced to utilize the most expensive transportation in the world, everything that we buy or ship back carries an additional burden. We also contribute with the social security and unemployment taxes which up to now has left a surplus that benefits the U.S. Treasury. Puerto Ricans also pay taxes to the U.S. Treasury on their income from any sources outside Puerto Rico, an amount which continues to increase. One of the most important ways in which we contribute is that as U.S. citizens, our young men and women participate in the military and many have given their lives in all of the wars in which the U.S. has participated in this century. A considerable reduction in Puerto Rico's economic growth would substantially affect all of our economic contributions to the mainland.

The section 936 companies operating in Puerto Rico today produce $7.5 billion of revenue per year. Of said amount Puerto Rico presently receives approximately $600 million of this income in income, tollgate and municipal taxes. As I stated above, Puerto Rico has first claim to tax this income since it is earned and sourced in Puerto Rico. The question with which we are presented today is essentially how much of the potential tax revenue that Puerto Rico could realize if it subjected the section 936 companies to Puerto Rico taxation should it share with the United States as a price for not destroying the Island's economy. How much do we have to pay to induce the Federal Government to change its position which, as proposed, would be a disaster to our economy. Obviously $8 billion is not fair. Puerto Ricans can not and should not pay more than twice the amount paid by residents on the mainland to reduce the nation's deficit.

I believe that Congress should study possible adjustments to income allocation attributable to intangibles that may result in a reasonable contribution to Federal deficit reduction without destroying our economy. We have done this in the past and we should do it again to do justice to all.

VI CONCLUSION

The Administration's wage credit proposal resembles the wage credit proposal rejected in 1985 by the Treasury Department and the Congress. At that time, they came to understand that a wage credit would hurt Puerto Rico's industrial development based on high-technology companies. Today, this is even more so. Since we have to comply with U.S. regulations, particularly minimum wage and transportation laws, and we have high costs of electricity and other utilities, the Puerto Rico economy will never again be competitive with other countries in the world for labor-intensive manufacturing. Thus, a wage-based credit, if applied to Puerto Rico, is bound to fail. This failure would be calamitous for Puerto Rico and its people resulting in widespread unemployment and poverty, and forcing the migration of many Puerto Ricans to the mainland. Proposed changes would limit unfairly and to a great extent Puerto Rico's capacity to tax the Puerto Rico source income earned by U.S corporate subsidiaries in the island.

In my judgement the issue should be considered from the standpoint of how much revenue Puerto Rico should be expected to contribute to U.S. deficit reduction. Once that is established, I suggest that an adjustment to the allocation of intangibles be studied that could produce U.S. tax revenue without abandoning the

concept of an income-based possessions tax credit. I believe, this is the direction which the Congress, the Clinton Administration and the present Puerto Rico Administration should follow if the issue is to be resolved in a manner that will not decimate the Puerto Rico economy. The proposal of the Clinton Administration, and indeed some of the proposals made by the Commonwealth Government representatives, would abandon the income-based credit, and thereby would cause enormous economic dislocation in Puerto Rico, with concomitant effects to the U.S. mainland, and probably no real tax revenue to the United States Treasury.

Chairman ROSTENKOWSKI. Thank you.
Mr. Lebrón.

STATEMENTS OF DANIEL LEBRÓN, PRESIDENT, PUERTO RICO MANUFACTURERS ASSOCIATION; AND ARTURO CARRIÓN, EXECUTIVE VICE PRESIDENT, PUERTO RICO BANKERS ASSOCIATION, BOTH ON BEHALF OF PUERTO RICO PRIVATE SECTOR 936 COALITION

Mr. LEBRÓN. Good morning, Mr. Chairman and distinguished members of this committee.

Thank you for the opportunity to address you today. My name is Daniel Lebrón, and I am president of the Puerto Rico Manufacturers Association, a trade organization that represents more than 1,800 members who employ approximately 200,000 workers in the production and service sectors of Puerto Rico's economy.

We come before you today, as we have in the past, to address the economic implications of section 936 which has been the most significant economic development tool ever placed in the hands of the Puerto Rican people. That tool, in conjunction with the Puerto Rico Industrial Incentives Act, has created a vital core sector of high-technology industries which represent Puerto Rico's basic chance to grow and expand, to remain competitive in the industrial technologies of the future, to reduce unemployment from its current level of 18 percent, and to increase our income per capita, which is still one-third of the U.S. mainland's average.

We will explain why we feel President Clinton's proposal to change section 936 for a 65 percent wage credit threatens to destroy that future and, more importantly, have immediate serious negative impact on our economy.

To begin with, it should be pointed out that section 936, and especially the high-technology sector, has had the profound impact on every aspect of Puerto Rico's economy. Consider, for example, that one of every three jobs in Puerto Rico is directly or indirectly generated by section 936 operations, and in the last decade high-technology industries, the industrial sector most affected by the proposed changes, have provided most of the manufacturing sector's employment growth.

Moreover, high-technology companies pay average wages of between $25,000 and $30,000 a year, which is about double the wages paid by labor-intensive industries that are not affected by the wage credit system. At the same time, these high-technology operations tend to spin off considerable economic activity from the goods and services they purchase locally. In addition, the high-technology industrial operations within the 936 sector have created a strong nucleus of line and management employees, with high degrees of technical experience and allocation of labors. The quality of those jobs is, therefore, an important factor contributing to economic expansion and entrepreneurship and remains Puerto Rico's basic hope of reaching a level of equality with our fellow American citizens in the U.S. mainland.

In addition, the companies operating under section 936 make significant contributions to broad economic activity on the island through bank deposits totaling around $10 billion which they generate. High-technology operations produce the bulk of this impor-

tant financial activity. Likewise, the taxes paid by high-technology operations to the Puerto Rico treasury are an essential source of funding for economic growth.

In 1992, section 936 companies paid around $600 million in taxes to the Commonwealth, representing around 15 percent of the government's total tax revenues from all sources. Clearly, the proposed change to section 936 you now have before you has broad and profound implications for the economy of Puerto Rico, because it attacks the very sector that is the foundation of that growth, the high-technology industries.

It is estimated that the change proposed by the Clinton administration will reduce tax credits for that sector by as much as 80 percent. The flow of section 936 funds into the economy and into the treasury of Puerto Rico will be reduced immediately by that amount. That will be a harsh blow to the 3.6 million U.S. citizens who reside in Puerto Rico. These citizens deserve not to be harmed by their successes, not to be penalized because of them.

We respectfully suggest that any option relating to possible modifications of 936 must, at the very minimum respond to Puerto Rico's critical need to assure its competitiveness as a site for promoting investment, for the continued growth of the industrial base that would create greater employment and promote Puerto Rico's economy.

Therefore, retention of an income-based option is as essential to the high-technology industries as a wage credit is to labor intensive corporations. We suggest that this committee work with all sectors of the Puerto Rican economy and with all interested parties to reach a balanced perspective on this issue.

Thank you for this opportunity to present the position of the Puerto Rico Manufacturers Association.

[The prepared statement follows:]

EXTENDED TESTIMONY FOR THE RECORD

Testimony Before the U.S. House of Representatives
Ways & Means Committee

On Proposed Changes to Section 936
of the U.S. Internal Revenue Code

Presented By Daniel Lebrón, President of the
Puerto Rico Manufacturers Association
and Héctor Jiménez-Juarbe, Executive Vice-President

April 1, 1993

Mr. Chairman and distinguished members of this committee, thank you for the opportunity to address you today. My name is Daniel Lebrón and I am President of the Puerto Rico Manufacturers Association, a trade organization that represents more than 1,000 members, who employ approximately 200,000 workers in the production and service sectors of Puerto Rico's economy. Accompanying me today is Héctor Jiménez-Juarbe, Executive Vice-President of our Association.

We come before you today feeling like old friends because have had the opportunity to appear before this committee several times in the past on the same subject. As a responsible trade association, each time we came before you we presented our best counsel on the impact of Section 936 on the economy of Puerto Rico. Each time, we demonstrated, to the best of our ability, what we regard as compelling arguments as to why Section 936, as we now know it, should not be changed.

Each time we have presented what we regard as sound data demonstrating the economic implications of changing Section 936. Those presentations have been based on the best economic analysis available to us and I respectfully refer you to the congressional record for whatever background that record may provide in your deliberations.

Essentially, Section 936 is a vital core sector that has stimulated important economic development thus far and holds substantial promise for further economic development. Let me emphasize that it is a core sector.

That fact was taken into account when Section 936 was first promulgated by Congress in 1976. That it has worked well is a testament to the soundness and justification of the program. How well has it worked?

We consider that the 936 program has worked very well in establishing a firm economic base in Puerto Rico, on which our local economy is building and diversifying. To change that program now for a wage-based credit will discriminate against the very high technology industries that have contributed to establishing the core sector necessary to Puerto Rico's continued growth.

IMPACT OF SECTION 936

Let us begin with one of the most important factors, although it is not the only factor: jobs. The 531 enterprises that operate in Puerto Rico under Section 936, provide 115,000 direct jobs, according to information furnished to us by the Economic Development Administration. This represents 72% of the 152,000 jobs created in Puerto Rico by the manufacturing sector. That means that almost three out of every four jobs in manufacturing are 936 jobs.

Each of the 115,000 direct jobs created by Section 936 generate, in turn, 2.6 additional jobs in our economy according to figures published by the Puerto Rico Planning Board. In other words, Section 936 represents more than a third of all the jobs there are in Puerto Rico today.

According to an on-going Planning Board Study, the growth of employment in Section 936 companies has offset the loss of jobs in non-936 companies. Preliminary findings of the study indicate that the manufacturing sector in Puerto Rico grew faster than the island's economy as a whole in fiscal 1992 and that 936 companies account for the bulk of manufacturing operations on the island.

The study also found that Section 936 companies increased their employment by 18,370 jobs between 1982 and 1987. That is about 1,000 more jobs than were created by the manufacturing sector as a whole during the period.

QUALITY OF JOBS

Notwithstanding the importance of the number of jobs - the quality of the jobs generated by 936 companies is equally important. In terms of direct compensation, Section 936 provides compensation and benefits to their employees that surpass other economic sectors. These include an average hourly wage of over $6.75, and fringe benefits such as medical insurance, retirement benefits, studies, vacations, cafeterias, etc. They also contribute substantially to the professional development and growth of their employees. They have been responsible for the creation of a strong nucleus of line and management employees with high degrees of technical expertise and education on the Island. We already have several examples of Puerto Ricans, who have assumed responsibility from Puerto Rico itself, from London, from New York, or wherever, for manufacturing operations in Europe, the United States, Central America, Singapore, and other distant places. 936 firms have been, are, and will continue to be a classroom for the Puerto Rican managerial and working class.

In no other sector of our economy, except in the universities, are there so many people, in proportion to the number of jobs, with bachelor's, master's, and doctor's degrees, as in 936 enterprises. This is so, because modern industry is continually getting more complex and sophisticated, requiring more technical and scientific knowledge, and more human and practical skills each day. Industry is a great school, and we are seeing more and more qualified people leave it to assume broader worldwide responsibilities, and to venture into their own entrepreneurial initiatives.

The manufacturing sector has experienced a great transformation in Puerto Rico since its beginnings in the 50's, when almost all industrial plan managers were imported. Today over 95% are native born. This is evidence of the profound impact that Section 936 has had on the quality of life.

The high technology industrial operations within the 936 sector have created a core of higher skilled jobs. Labor statistics indicate that the number of high technology manufacturing jobs on the island rose by about 10,000 to nearly 60,000 over the past decade. Moreover, high tech companies pay average wages of between $25,000 and $30,000 a year, which is about double the wages paid by low tech industries. At the same time, high technology operations tend to spin off considerable economic activity from the goods and services they purchase locally.

A BROAD AND GROWING MARKET FOR LOCAL MANUFACTURING AND SERVICE SECTORS

A survey made by the Puerto Rico - U.S.A. Foundation (PRUSA) in 1989, revealed that twenty-one 936 enterprises spent $280,937,039 in the purchase of goods and services in Puerto Rico and that in

1990, twenty-four 936 firms invested $537,701,947 in the acquisition of goods and services in Puerto Rico.

The manufacturing industry, particularly the 936 sector interacts with all the sectors of our economy, with the United States and our neighbors in the Caribbean. We shall discuss each of these in more detail.

Let us start in the area of professional services, on which the 936 sector has a very deep impact. Prior to initiating its operations, each 936 manufacturing enterprise established on the Island uses legal, design, construction, accounting, insurance and many other categories of services. The majority of these services are contracted in Puerto Rico from Puerto Rican firms. After operations commence, the contracting of legal, accounting, insurance brokerage, and many other professional services, represents a large contribution to our professional sector.

Let us now look at the area of purveyors of other services. These are many, varied, and practically all, are local. Maintenance and calibration of equipment and facilities, cleaning and security, collection and disposal of waste, making and laundering of uniforms, cafeteria services, and printing, are only some of these.

The 936 companies buy a large amount of goods and materials from Puerto Rican firms. These include corrugated cartons, plastic and glass containers, labels, chemical products and manufacturing components. In the case of exported articles, they are bought through local agents and distributors. This domestic market has already given rise to the creation of several native enterprises, which will be discussed in greater detail later.

Companies operating under Section 936 also make a significant contribution to broad economic activity on the island through the passive income they generate. It is estimated that more than $12 billion in so-called 936 funds currently flow through the island's financial system, creating significant economic activity in infrastructure development, housing, construction, manufacturing, and service operations and commercial and retail enterprises.

Consider also the impact on philanthropy. PRUSA's survey, which was mentioned earlier, revealed that in a period of less than three years, between 1989 to 1991, thirty-four 936 firms with operations in 89 locations in Puerto Rico, donated a total of $18,213,000 to various causes, projects and programs in Puerto Rico. Fondos Unidos de Puerto Rico (United Way), which collected around $8 million in its annual campaign, receives around 70% of its contributions from 936 companies and their employees, through voluntary payroll deduction and corporate donations. The Puerto Rico Foundation, which in seven years, has collected over $17 million to carry out its community assistance projects, receives about half of this support from 936 companies.

The "Adopt-A-School" program which was begun by 936 companies, and is officially endorsed by our Association, which, according to our records, has already spread to more than 160 schools on the Island is benefitting thousands of students. According to the Department of Education, the total number of schools that have benefitted thereby is closer to 300, since many 936 and non-936 enterprises assist schools in their immediate community without participating in our program which won the praise of Congress in 1988 for its substantial merit.

In addition, the 936 companies' health plans have had considerable impact on our health professionals. Practically all of the 115,000 employees in the 936 sector, and their immediate families, a population of over 300,000 persons, are covered by health plans that include medical, dental, hospital, laboratory, and clinical services of various types.

EFFECT OF SECTION 936 IN THE UNITED STATES

Consider also what Section 936 means to the United States and the interests of the United States in the Caribbean. Section 936 contributes to the creation of economic activity in the United States itself, and to further its foreign policy objectives in the Caribbean. It is accepted that the activity generated by Section 936 in commercial trade between the Island and the Mainland generates some 150,000 jobs on the Mainland. Today, Puerto Rico is the tenth most important United States market in the world. This is possible, to a great extent, through the economic impact of Section 936.

There are other very important areas in which Section 936 contributes to the national economy as well. The United States merchant marine is one of the most expensive in the world. However, it is a vital component of the national security, and is essential in times of armed conflicts. The extensive use of the merchant marine by 936 companies in Puerto Rico, and the Mainland, contributes significantly to maintain the service.

In addition, few people are aware that in the high technology sector in particular, the benefits from Section 936 have made it possible to support scientific research. By contributing to the speedier discovery and development of new products, 936 has made it possible for these industries to keep their competitive edge in the world market.

IN THE CARIBBEAN

In the Caribbean, 936 enterprises have been the only important positive factor in fulfilling the United States' policy of stimulating the economic development of the neighboring countries. The Twin Plants program, which was begun a few years ago, has already established 58 complementary plants in the Dominican Republic, Costa Rica, Guatemala, Dominica, Grenada, and Barbados. This program has not cost any jobs in Puerto Rico, but has created new jobs, by exporting manual labor to the complementary plants which would otherwise have been lost to lower-cost Asian competitors, and creating more jobs here to finish the components produced in the Twin Plants. In addition, the 936 Fund Loan Program has already loaned around $1 billion for infrastructure in our neighboring countries. This fully complies with the expectations defined in 1988, of using these funds to help to raise the economies of the Caribbean Basin countries, and thus meet the foreign policy objective of the United States.

As of February 1991, $647 million ($492 million of which is from 936 deposits) has been approved for investment in 87 Twin Plants and other projects in the Caribbean. These projects are estimated by the Caribbean Development Office to involve 2,575 jobs in Puerto Rico and 19,726 jobs in the Caribbean Basin.

EDUCATION

We already discussed the "Adopt-A-School" program, which has had a great impact on elementary and secondary schools. At a higher level, 936 companies have contributed significantly, through scholarships, to the creation of special educational programs, and to the increase in number and quality of graduate programs. They also support scientific investigation in universities through their donations to institutions such as INDUNIV, the University-Industry Investigation Center, which has contributed over $1 million to some thirty research projects by scientists in our universities over a term of six years.

TOURISM

With regard to the tourism industry, which is now subject to special attention in the Puerto Rico government's priorities, a good portion of its health depends on 936 companies. Executives,

auditors, technicians, foreign suppliers, clients, and others who visit the companies, are the type of client that come here during the entire year. Ask any hotel manager how much the backing of the 936 enterprises and the number of conferences held in their hotels, adds up to each year. Also, ask any airline sales manager or travel agent how much of their business is tied to 936 firms to appreciate how much they contribute to the tourism industry's economic welfare.

TAXES

Many people have the totally-mistaken impression that 936 companies pay no taxes. Nothing could be further from the truth. According to the Puerto Rico Treasury's own reports, 936 companies pay more income taxes than all the other corporations together. They also pay around $50 million, in municipal license taxes, according to our estimates. They also pay a special tax of .075% on their sales for the Excellence Fund for our teachers and members of the police, and the scientific research fund. In total, the 936 sector in Puerto Rico pays our Treasury around $600 million a year, which represents approximately 15% of total tax revenues from all sources. And this, naturally, does not include payroll taxes on the 115,000 direct 936 jobs that are estimated at around $200 million a year. Clearly, 936 companies do generate and pay taxes to Puerto Rico.

WHAT IF 936 COMPANIES ARE ELIMINATED?

"What would happen if Section 936 is eliminated?" We don't pretend to have a complete answer to that. What we do want to do is to describe the picture of what really could happen in a typical industry.

First, let me make it clear that the decision to remain in Puerto Rico if Section 936 is eliminated or modified, is one that each industry, each firm, would have to make according to its particular situation.

The 936 enterprises are varied. There are small ones, with little capitalization which can be moved easily from one place to another. They can leave the country immediately. Others are very large with great capital outlays, and obviously, they cannot do the same as easily. They will remain for a while - some of them for many years - but how would they operate?

Modern industry is not a static operation where everything is done the same way year after year. Modern industry operates in a very agile, dynamic and fiercely-competitive world. The demand for products in the marketplace changes almost from one day to the next. There are emerging countries such as Malaysia, Indonesia, and India, with populations which are better trained each day, and whose salaries are around a tenth - or less - of those we pay. With modern communications, it no longer matters whether they are on this side of the world or the other. What does matter, is to satisfy the changing demand, as economically and productively as possible, because if it is not done, someone else will do it and take over the market.

That is why industry must be dynamic, and always prepared to introduce new products to satisfy new demands, and to adopt new procedures to make their products more efficiently. We have been saddened to see how distinguished names such as Lotus, Digital, and a few years ago, Atari and Wang have disappeared from our community because of changes in the market or production changes forced them to leave.

The tax exemption incentive that 936 offers has no value if there are no profits on which to apply the exemption. Therefore, the industries that would remain if the incentive is reduced or eliminated, would no longer bring new products to Puerto Rico. They would take them to a new plant in one of the many countries that offer tax incentives.

This is where the U.S. Treasury Department is fully mistaken. It believes that if Section 936 is eliminated, all the industries that are established in Puerto Rico would return to the United States, or continue to operate in Puerto Rico under the new rules and with the same level of production. This could have happened fifty years ago, when the world was static and controlled by a rigid industry with slow and tortuous communications, not today. Industries would seek alternatives in other parts of the world and as a result, the United States would not get the additional taxes that it is looking for to relieve the budget deficit. In other words, we would all lose: the United States, and above all, Puerto Rico.

A typical industry in Puerto Rico would go on producing traditional products, for a time until it suffers the fate of every consumer product which after a certain time on the market loses its attraction because new and better products are available, until it eventually disappears. The process would be slow, sad, but sure. The plants would have an accelerated obsolescence until the cost of operating them would not be justified in view of the diminished income the products would generate. They would eventually close, destroying a costly effort, and leaving behind a monument to despair throughout the Island, such as what happened to the petrochemical industry on the South coast of the Island. Meanwhile, in those last years, the plants would lose their best manpower. The most competent manager would no longer find a challenge in them. The highly skilled operations would have to find work outside of Puerto Rico, and the talent drain would be accelerated dramatically.

Pursuant to the most recent study made on the economic impact of Section 936 on Puerto Rico's economy ("Benefits and Costs of Section 936", Price Waterhouse, May 1991), let us look at what would happen if Section 936 were eliminated:

A. PRODUCTION

In a period of five years from the repeal of Section 936, the gross national product would fall from 11% to 16%, relative to the level that it would have had if the Section had remained. In all the simulations made, the annual rate of growth of the gross national product over the five years immediately before the repeal, is negative. Comparatively, this behavior would imply a economic recession in Puerto Rico much longer and deeper than any seen in the United States after the Second World War and comparable only to the Great Depression of the 30's. Investment would experience a contraction of 6% to 7.5%, together with a drop in the levels of consumption of 8.3% to 8.0%. The behavior of production and investment would produce substantial loss of available personal income to Puerto Ricans, which would drop of 11.1% to 12.1%.

B. EMPLOYMENT

The elimination of Section 936 would cause a rise of 164,000 unemployed in Puerto Rico in a period of five years from the date of its repeal. This rise would practically double the 186,000 unemployed reported in 1991. This rise would increase the unemployment rate to 31.4%.

C. FINANCIAL MEDIATION

The results of the Price Waterhouse survey on the elimination of Section 936, indicate that practically all 936 deposits would be withdrawn from Puerto Rico's financial system. Thus, two additional effects would be generated on the economy of Puerto Rico, on the direct effect of production and employment generated by the manufacturing enterprises that were described before. The first effect would be seen in the level of direct employment in the finance and real estate industry which would show a drop of 36,000 jobs. The second effect on direct employment would be on

the jobs generated by 936 funds. The reduction in the amount of available capital in the system would cause a grave problem of availability of resources for economic development, mainly in the construction sector.

D. GOVERNMENT RESOURCES

Using as a basis the reduction in taxes paid in proportion to the reduction in exports (and in production), it has been estimated that by the fifth year after the repeal, taxes received by the Commonwealth Government would drop by 60%. Substitution of this income would imply an increase in the level of other taxes equivalent to 9%, or a reduction in expenditures of 8.1% for the Commonwealth Government.

Price Waterhouse's estimates do not take into consideration the additional effects of tax collections that would be generated for the Commonwealth Government because the job reductions in 936 enterprises and employment in the financial sector. These, undoubtedly, would be important in view of the pyramid nature of our tax system.

Finally, is there an alternative to 936, or are we condemned to depend on it for an indefinite time?

There is an option, but only a long-term one. We are already seeing the first signs, which we could call the fruit of 936. These are the many firms which have already been established by local entrepreneurs, forged by years of experience, in 936 companies, where they have acquired the technical knowhow, the management skills and the global view of the modern market-place, which have allowed the establishment of new industrial enterprises that are fully Puerto Rican. Some of these new firms are still closely tied to the 936 sector because they have been established to give them services of one type or another. But little by little, they are already establishing their own place in the local, as well as the international markets.

Let us look at only a few of these companies:

- Borinquen Container, in Hatillo, makes corrugated cartons and fiber casks. It employs 230, and 75% of its sales are to 936 companies.

- Demaco, in Guayanilla, does industrial maintenance and demolition, and distributes solvents. Founded by a former employee of a 936 firm, it employs 150 and 80% of its sales are to 936 enterprises.

- MOVA Pharmaceutical, in Caguas. Founded in 1986 by a former manager of a 936, it employs 500 and in addition to manufacturing by contract for two 936 firms, it is already developing and manufacturing its own product lines.

- Steri-Tech, in Aguadilla, was founded in 1984 by a former 936 employee, it sterilized equipment and uniforms for companies, mostly 936's. It employs 72.

- Cortés Industrial Organization, Inc., in San Juan, reconstructs motors and machinery. Seventy percent of its services are to 936 companies.

- Quality Electroplating and Antilles Electroplating, dedicated to serve 936 companies, they employ more than 160.

- Tri-Line Co., Inc., in Manatí, prints labels and instruction inserts for medicines. The company, which competes with three other local companies for a $70 million annual market, employs 114 persons.

It is important to note that two of the companies mentioned are already changing their view of operations because of prospective

changes to Section 936. Enrique Cortés, president of Cortés Industrial, recently stated that to prepare for the possible loss of that business, he has frozen hiring, cut costs, and postponed expansion. Ron Salzano, president of Tri-Line, recently stated that the company has put expansion plans on hold pending the outcome on Section 936. The expansion would have involved an $850,000 investment in equipment and created 10 additional jobs.

There are many more such companies. What is important is to recognize that our local industrial sector should be encouraged and helped to the maximum so that it can be that industrial foundation of our economy. None of the large companies of the world started out large. Thanks to 936, we have the great advantage of counting on many of those global enterprises to help to develop local enterprises. Besides generating jobs and economic activity, they are the classrooms in which the foundation of our future is being developed.

As an option to complement Section 936 and try to reduce our dependence on this mechanism for development, the Association is promoting programs to develop Puerto Rican industry and lead it to competitive world levels. As part of this process, we are working at present with 11 local firms, using the resources of Puerto Rico 2000, an organization that promotes competitiveness. These, in turn, have assumed the commitment of taking the experience and knowledge they acquire to other Puerto Rican enterprises so that the field of action will grow each day and we can reach the largest number of enterprises.

This month, we will also announce a campaign to promote Puerto Rican industry and the consumption of its products. This campaign is being conducted jointly with the Economic Development Administration, a group of local firms, and with the Association's financial contribution. Within this same field of action, we have created a task force which, together with the Economic Development Administration, will seek methods to promote exports through the establishment of "trading posts" in the United States and eventually, in other places. We are also reinforcing our relationship with similar associations in the United States and in Latin America; in the latter case, in order to obtain the best possible advantage from the opportunities of the Free Trade Agreement between the United States, Canada and Mexico. But the process takes time. It cannot be achieved in two, nor ten years. Perhaps not even in 20. It has taken us 40 years to get to where we are now. This achievement is recognized as an economic miracle in the context of the global economy. While we develop options, we need Section 936 exactly as it is now.

Without Section 936 as it now stands, however, that developmental process will be stopped because of the lack of growth fostered by high technology industries.

Without Section 936 as it now stands, Puerto Rico will be thrown back in time to the difficult conditions before high tech industries opened the door to create a high income core sector.

Without Section 936 as it now stands, most of our best trained and educated people, who now have a bright future because of high tech industries, will seek economic opportunities elsewhere at a time when we need them most to prosper and grow.

The 3.6 million American citizens who reside in Puerto Rico deserve better than that. They deserve to build on their success, not to be penalized because of them.

This congressional body, therefore, has a truly difficult task. We appreciate that the sacrifices you will be asking the American people to make are necessary to the revival of America's competitiveness and to its ability to grow and prosper for the future. We support that important effort and we are willing to contribute to it.

We cannot, however, do so if our economy is gutted by drastic changes to Section 936. The proposal you have under consideration in this regard will make Puerto Rico a bigger economic burden to the U.S., instead of a part of the solution for all Americans.

Any consideration to modifying Section 936 must seek to assure that Puerto Rico remains economically viable. In order to accomplish that goal, we regard the following to be the minimum requirements:

1. Maintain and improve the job generation achieved under Section 936, in quality as well as number.
2. Maintain and improve the level of investment generated under the 936 system.
3. Maintain the development of high technology Industries, as well as labor intensive industries.
4. Stimulate investment in plant and equipment for production in Puerto Rico.
5. Improve the competitiveness of Puerto Rico as a site for investment.
6. Stimulate the development of Puerto Rican Industries to expand economic development.

Unfortunately, our Association must take the position that none of the proposals made thus far to alter Section 936, including the proposal made by Puerto Rico's Resident Commissioner, Carlos Romero Barceló, meet these essentials. The most recent alternative proposal was made by Puerto Rico's Governor Pedro Rosselló. While his proposal is thus far the best, it still falls far short of meeting the basic requirements for continued economic development.

Governor Rosselló's proposal is estimated to produce $6.4 billion from Puerto Rico sources. We regard that amount to be substantially above any consideration of a fair share participation in the sacrifices being asked of other Americans.

The proposal also makes no provision for phasing in the changes so that the full impact will be felt immediately with a tremendous shock to the economy.

We are concerned that the level of 936 funds invested in the Puerto Rico financial system and economy, now estimated at $12 billion, will be significantly reduced, resulting in insufficient funding of important activities and higher interest rates for business and consumers.

We are concerned that the proposal will result in increased tax collections by the U.S. government at the expense of the Puerto Rico economy, and will result in reduced tax collection by the Commonwealth government and the municipalities from business and individuals. Puerto Rico has many significant problems - crime, infrastructure, etc. We cannot afford to lose economic activity which supports public sector funding.

Most of all, the proposal continues to discriminate against high technology industries, which are our most important building-block for continued economic development. If those high technology industries cannot invest and grow on the Island, the very basis for the industrial future of Puerto Rico will be negatively changed. The result will be that everything we have worked for over the past 40 years will be brought to a stand still. Puerto Rico will revert to a low wage, labor intensive industrial base, where it can no longer compete.

We, therefore, respectfully suggest any that option in relation to possible modifications to Section 936 must, at the very minimum, respond to Puerto Rico's critical need to assure it's competitiveness as a site for productive investment in plant and equipment and to stimulate investment for the continued growth of

an integrated industrial base that will create greater employment.

Thank you for this opportunity to present this position of the Puerto Rico Manufacturers Association.

Chairman ROSTENKOWSKI. Thank you.

Mr. Carrión.

Mr. CARRIÓN. Good morning, Mr. Chairman and members of this distinguished committee.

My name is Arturo Carrión and I am here today as the spokesman for the Puerto Rico Private Section 936 Coalition, 29 organizations that have joined to preserve our blueprint for economic development. The organizations in this coalition represent approximately 30,000 businesses of all sizes and from all sectors of Puerto Rico's economy, which account for more than 50 percent of total private employment in Puerto Rico.

For the record, I am submitting a full written statement, including a list of the organizations in the coalition and a summary of the impact which the issue at hand will have on each economic sector represented.

We are conscious of President Clinton's call for sacrifice by all Americans to strengthen the U.S. economy. However, this sacrifice must be shared equitably among all Americans. This is not the case with the administration's proposals as they pertain to Puerto Rico.

Puerto Rico is being asked to carry a disproportionate share of the tax burden in the President's program. We are the only jurisdiction being asked to put at risk the very foundation of our economy. The administration has two clear-cut objectives, to raise revenues and to create jobs. Both are simple and clear. Neither of them requires or justifies the sweeping changes in Puerto Rico's economic structure that are being proposed.

The revenue-raising proposals in the administration's program totaling $246 billion amount to slightly less than $1,000 for each American citizen in the mainland. In contrast, the $7.5 billion being asked from Puerto Rico's economy are more than $2,000 for each of Puerto Rico's 3.6 million American citizens. If we factor into the calculation the fact that Puerto Rico's income per capita is about one-third of the income per capita on the mainland, we find that the proportionate share of the tax-raising burden place on Puerto Rico is six times higher than the corresponding burden on the mainland.

Since the late 1940's, we have increased our per capita GNP 18-fold, from $348 in 1950 to $6,450 today. Employment has increased more than 50 percent in that period. Section 936 and its predecessors have been instrumental in these achievements.

Even with these achievements, Puerto Rico must still compete without natural resources, one of the world's highest population densities and a per capita income of about half that of the poorest State. In contrast to many countries that compete with us for investment capital, we are bound by some of the toughest environmental standards in the world, by U.S. minimum wage laws, by the customary maritime transportation in U.S. bottoms, and by higher energy costs than the mainland.

Creating jobs is ultimately the main thrust of the President's economic program. Section 936 is essential, if Puerto Rico is to continue doing just that, creating jobs. Besides generating 115,000 direct jobs, the activities of 936 companies support about 200,000 additional jobs in services trade, retailing and many other activities,

characterized by medium- and small-size companies led by Puerto Rican entrepreneurs. These are the people represented by this coalition.

In the financial sector, 936 companies supply more than 40 percent of all financial resources available for lending and investment in productive employment-generating activities. In advancing the objectives of the administration's program, Treasury has recognized the importance of section 936 and has proposed a wage-base limitation to the 936 credit. However, we must state that this proposal is not an adequate alternative.

In view of the need to protect the benefits which the economic system based on section 936 represents for Puerto Rico, we submit that any modifications considered necessary to the 936 system must conform to parameters that are indispensable to ensure Puerto Rico's ongoing economic development. In harmony with the objectives and needs of the U.S. economy are the following:

Puerto Rico must answer President Clinton's call to sacrifice in proportion to its capabilities, as the lowest income and highest unemployment economy within the United States. Puerto Rico's economic model must be capable of fostering a favorable environment for creating jobs, generating income, enhancing the cross linkages within all the sectors of the Puerto Rican economy, and supply funds for low-cost financing of public infrastructure and private productive activities.

Modifications to improve the 936 system must provide for the continued stability of Puerto Rico's investment climate and its attractiveness for future investment and job creation. Finally, modifications to the current 936 system must be implemented on a gradual basis, to give the economy time to readjust its basic underpinnings.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

STATEMENT OF THE PRIVATE SECTOR 936 COALITION

TO THE COMMITTEE ON WAYS AND MEANS

OF THE HOUSE OF REPRESENTATIVES

ON THE PRESIDENT'S ECONOMIC PROPOSAL

April 1, 1993

Good morning Mr. Chairman and members of this Honorable Committee. My name is Arturo Carrión and I am here today as the spokesman for the Puerto Rico Private Sector 936 Coalition, a group of 27 organizations that have joined together to preserve our blueprint for economic development.

The organizations in this Coalition, together represent more than 30,000 businesses of all sizes and from all sectors of Puerto Rico's economy, and these businesses in turn account for more than 50% of total employment in Puerto Rico.

These private-sector organizations agree with the ongoing effort to create jobs, improve US competitiveness, and reduce the federal budget deficit. We also believe that Section 936 of the Internal Revenue Code is vital to the continuing economic development of Puerto Rico. It is in this context that I deliver this message today on behalf of the Coalition.

For the record, I am attaching a summary of the impact which the issue at hand, will have on each economic sector represented in the Coalition.

As we address this hearing on the Administration's economic program, we are conscious of President Clinton's call for sacrifice by all Americans to restore health and vitality to the US economy. However, this sacrifice must be shared equitably and fairly by all Americans. This is not the case with the Administration's proposals as they pertain to Puerto Rico.

Puerto Rico is being asked to carry a disproportionate share of the tax burden in the President's program. We are the only jurisdiction being asked to put at risk the very foundation of our economic system. The proposed changes to Section 936 are not merely an incremental adjustment in taxes, but a radical change in our economic structure. Sound policymaking requires a full understanding of the derivative effects of such a change.

The objectives being pursued by the Administration do not warrant this dangerous change in Puerto Rico's economic system, and can be achieved in more effective and less risky ways. Our understanding is that the Administration has two clear-cut objectives: One is to raise revenues. The other is to create jobs. Both are simple and clear goals; neither of them requires or justifies the sweeping changes in Puerto Rico's economic structure that are being proposed.

Aside from their far-reaching nature, the dollar value of the changes being proposed also has a dramatic impact. When differences in population and income are taken into account, we find that Puerto Rico is being asked to carry a burden six times as large as the burden on the mainland economy. Moreover, the proposed changes in Section 936 imply enormous increases in the effective tax burden on the economy of Puerto Rico that would cause irreversible harm to the entire economic development program on the Island. This is too high a sacrifice for Puerto Rico to bear.

The revenue-raising proposals in the Administration's program, totaling $246 billion, amount to slightly less than $1,000 for each American on the mainland.

In contrast, the $7.5 billion being asked from Puerto Rico's economy are more than $2,000 for each of Puerto Rico's 3.6 million American citizens. If we factor into the calculation the fact that Puerto Rico's income per person is about one-third of the income per person on the mainland, we find that the proportionate share of the tax-raising burden placed on Puerto Rico is six times higher than the corresponding burden on the mainland.

Viewed from another perspective, the $7.5 billion requested from Puerto Rico in five years, which translate into $1.5 billion per year on average, is equivalent to a 43% increase in Puerto Rico's annual tax burden. In other words, raising $1.5 billion per year in tax revenues out of Puerto Rico's developing economy is like a 43% increase in local taxes, none of which will be spent on development-oriented activities in Puerto Rico. Picture such an increase in the tax burden on any state or municipality on the mainland. Changes of such magnitude cannot take place without causing severe disruption in economic activity.

Whichever way one looks at the proposed changes in Section 936, the magnitude of the change is staggering. We have no doubt that changes like those being proposed would cause severe hardship to those in Puerto Rico who are least able to escape the negative impact of this economic dislocation.

In the four-and-a-half decades since the late 1940s, we in Puerto Rico have taken full advantage of Section 936 and its predecessors to produce a dramatic transformation of our economy and society. We have increased our GNP per person eighteen-fold, from $348 in 1950 to $6,450 today. Employment increased more than 50%, from 596,000 in 1950 to 925,000 presently. In the process, we transformed a traditional agricultural economy into a modern and dynamic manufacturing and services economy. We have also modernized all aspects of Puerto Rican life, reaching world standards in matters of education, health, life expectancy and other indicators of economic development. Section 936 and its predecessors and the active mobilization of Puerto Rico's own constructive energy have been essential to this process.

Yet, after four-and-a-half decades of impressive achievements we still face major shortcomings in our economic development. It is because of these shortcomings that Puerto Rico's economy is not strong enough today to carry the burden implied by the proposed changes in Section 936.

When Puerto Rico's modern industrial development began in the late 1940's, we had three major advantages to build upon. First, we had preferential access to the United States market under a common currency and common customs. Second, we had a low-cost labor force. Third, we had local and federal tax benefits for industrial corporations. Besides these three pillars of our industrial strategy, we also had lower energy costs due to exemption from oil import quotas.

As we leveraged on these advantages, we developed our human resources to the point where cheap labor is neither a possible nor a desirable feature of the Puerto Rican economy. Through the years, we have also lost the advantages of our preferential access to the US market, not because the market has been closed to our products, but because many other countries have gained almost equal access to the US market. The two rounds of GATT negotiations, the Caribbean Basin Initiative, and more recently, the proposed North American Free Trade Agreement, have given many other countries such easier entry into the American market that our free access is no longer so advantageous.

We have made a good deal of progress towards our goal of sustaining economic growth on the strength of our human resources, our entrepreneurial ingenuity, and our physical and technical infrastructure. However, we still need an instrument to support economic development in the foreseeable future.

We must recognize that despite all the achievements of the last four decades, Puerto Rico must still compete without natural resources, with a population density that is one of the highest in the world, and a per capita income that is still only about half that of the poorest state. We should also remember that in contrast to many countries that compete with Puerto Rico for investment capital, we are bound by some of the toughest environmental standards in the world, by US minimum wage legislation, by the cost of maritime transportation in US ships, and by higher energy costs than the mainland.

We have to continue this transformation on the basis of the partnership historically developed between the federal government and Puerto Rico in order to compensate for the challenges that Puerto Rico faces. The Honorable Baltasar Corrada del Río, Secretary of State of the Commonwealth of Puerto Rico, in his testimony before this Honorable Committee on March 17, 1993, quoted the Honorable Daniel Patrick Moynihan, Chairman of the Senate Finance Committee, as follows: "Section 936 is part of the arrangements we offer for economic development in possessions of the US. It is their due, they do not have many rights as possessions as it were."

This tax-sparing arrangement has always been recognized by the US government since the beginning of the century, is customary practice in relations between other industrial countries and many developing countries, and has proved beneficial to both Puerto Rico and the United States.

Puerto Rico is one of the world's largest purchasers of US products, with imports of more than $10 billion annually. This places us as the single largest buyer of US products on a per capita basis and just below such a large and high-income country as France in terms of the dollar value of purchases. These purchases of US products, many of them raw materials and supplies purchased by 936 corporations, support about 200,000 jobs on the mainland. In addition, Puerto Rico's heavy use of US merchant marine services is instrumental to the survival of this strategic industry.

Creating jobs, particularly high-quality, well-paid jobs, is ultimately the main thrust of the President's economic program. We maintain that Section 936 is essential if we are to continue with our economic development and our endeavor to create jobs. That is what 936 means to our economy. It is the mechanism that creates employment in Puerto Rico. Besides generating 115,000 jobs directly in manufacturing, the activities of 936 corporations indirectly generate and support about 200,000 additional jobs in services, trade, retailing, and many other activities characterized by medium and small-size companies led by Puerto Rican entrepreneurs. These are the people represented by this Coalition.

In the banking industry, approximately 35% of total deposits are 936 funds and the financial system as a whole, including broker-dealers and thrifts, intermediates approximately $10 billion from 936 companies. This produces, due to the operation of local financial regulations, $12 to $13 billion in economically-productive, employment-generating investments and loans. Additionally, 936 companies directly hold investments of approximately $5 billion, consisting of PR government securities, various forms of residential mortgage obligations and bonds of the Puerto Rico Industrial, Medical, Education and Environmental Control Financing Authority (AFICA) and of the Caribbean Industrial Financing Authority (CARIFA). That is $18 billion employed in productive investment assets. These "936 funds", which have permitted the emergence of modern capital markets in Puerto Rico, have provided low-cost financing essential to Puerto Rico's development. The preservation of this source of funds is essential to preserve Puerto Rico's economic growth.

In fiscal year 1992, 936 companies paid an estimated $600 million in taxes to the Puerto Rican government and its municipalities in one form or another. This is more than half of total corporate tax payments. Unemployment is high, but without 936 companies it would be substantially higher. While total

employment in the manufacturing sector has remained stable over the last ten years, over 20,000 jobs have been lost through plant closings while an almost equal number have been added through new openings thanks to the industrial incentives made possible by Section 936.

Section 936 has also helped to promote economic growth and stability throughout the Caribbean Basin. Direct investments under Puerto Rico's Twin Plant Program and lending for development-oriented projects have been possible thanks to an agreement between Puerto Rico and the Congress to put 936 to work in furtherance of our economic and political goals in the Caribbean.

In addressing the objectives of the Administration's program, the Treasury has recognized the importance of Section 936 and, on that basis, has proposed a wage-based limitation on the 936 credit. However, we must state that the wage credit proposal being advanced as a replacement for the 936 system is not an adequate alternative. The wage credit proposal is not a new idea; it had been proposed before and it had been rejected by Congress.

There are several reasons why a wage credit by itself is not an adequate alternative to Section 936. A wage credit would hurt the industries that have been responsible for most of the employment creation in Puerto Rico in the last two decades. These are the high-technology, capital-intensive manufacturing industries. In contrast, the wage credit is supposed to benefit the labor-intensive manufacturing industries that have been losing employment and have suffered a declining trend in Puerto Rico even under the current system of an income-based credit.

Even with the proposed wage credit, Puerto Rico's effective wages would still not be competitive when compared to Mexico and the majority of the CBI countries. Therefore, it is unlikely that the wage credit will give us an advantage in labor-intensive industries. On the other hand, it is certain that it will definitely hurt our present competitiveness in high-technology industries. An analysis of the Administration's proposal by the Government Development Bank for Puerto Rico shows that 25% of direct 936 jobs would be affected by the wage credit proposal.

We are even more concerned with the dynamic effects of a wage credit. By this we mean the medium and long-term effects of a wage credit on our future economic development. We must maintain the incentives to remain at the forefront of high-technology industries if we are to continue to develop our human, physical and technical resources as we have during the past four decades. We cannot accept a wage credit, if it eliminates our ability to attract and keep this type of industry. In effect, that would be asking us to renounce the benefits of high-technology development essential to compete in today's global economy.

This is not to say that we want to abandon the labor-intensive industries that still account for a substantial portion of total employment in Puerto Rico. What we do need is a mechanism to balance the continued development of high-technology industries with the necessary support and strengthening of more traditional manufacturing.

In view of the need to protect the benefits which the economic system based on Section 936 represents for Puerto Rico, we submit that any modifications considered necessary to the 936 system must adhere to certain parameters that are indispensable to ensure Puerto Rico's continuous economic development in harmony with the objectives and needs of the US economy. These parameters are the following:

- Puerto Rico must answer President Clinton's call to sacrifice in proportion to its capabilities as the lowest income and highest unemployment economy within the United States.

- Puerto Rico's economic model must be capable of fostering a favorable environment for creating jobs, generating income, enhancing the cross-linkages between all the sectors of the Puerto Rico economy and supplying funds for low-cost financing of public infrastructure and private productive activities.
- Modifications to improve the 936 system must provide for the continuous stability of Puerto Rico's investment climate and its attractiveness for future investment and job creation.
- Puerto Rico must retain the ability to attract high-technology industries while strengthening labor-intensive industries.
- Modifications to the current 936 system must be implemented on a gradual basis to give the economy time to readjust its basic underpinnings.

Thank you.

ATTACHMENT 1

ECONOMIC IMPACT ON SEVERAL SECTORS OF OUR ECONOMY

Following is a summary of the estimated effects of the proposed changes in Section 936 on each economic sector represented by the Coalition. We have not included in this summary the manufacturers' position, since they will testify separately from the Coalition owing to the direct impact that these proposals have on their operations. However, the Puerto Rico Manufacturers Association is one of the members of this Coalition.

FINANCIAL SECTOR

Should the financial system in Puerto Rico suffer a significant reduction in the 936 funds, it would face a severe liquidity problem. This, in turn, would have negative repercussions on the Puerto Rican economy, to the extent that the financial intermediaries would be forced to restrict credit to the employment-generating sectors of our economy and reduce their purchases of government bonds.

The reduced liquidity would impact the economy in two ways:

- a higher cost of funds as the 936 funds in the market are reduced; and
- a reduced availability of credit as the 936 funds are reduced and the condition of the economy deteriorates as a consequence of a gradual increase of the unemployment rate.

This liquidity crunch would affect the four main intermediaries of 936 funds in similar ways. However, owing to their particular business nature and capital structure, each of the major intermediaries would be affected to varying degrees, as explained below.

Commercial Banking Sector

Even though liquidity would suffer, commercial banks, in general terms, could replace the 936 funds from external sources, but at a higher cost and, in all probability, with reduced availability. This, in turn, would affect the availability of credit to most, or all of Puerto Rico's economic sectors and would raise the cost of credit to levels much higher than at present. On the other hand, commercial banks, particularly those with concentration on the retail, commercial and mortgage markets, would probably suffer a higher delinquency and foreclosure rate as the condition of the economy deteriorates. Needless to say, the internal generation of capital would be negatively affected as profits would most probably be reduced as a function of higher loan losses. This is also true of other financial intermediaries.

Savings Banks

Savings banks, by their corporate nature, are 936 companies. As such, they do not pay US taxes but pay taxes to the Puerto Rican government (18 million dollars in 1991). Any change to Section 936 would force them to pay an equal amount in federal taxes. They would claim a tax credit in Puerto Rico, thus reducing the tax revenues for the government of Puerto Rico.

Like the commercial banking sector, but with greater severity, the savings banks would suffer a serious liquidity limitation. Any reduction in the credit granted to the 936 companies would have an immediate effect on the investment income and, consequently, on the deposits intermediated through the financial system. The savings banks would be mostly affected due to the marginal nature of their operations in this market. Without this liquidity, the mortgage origination which

has been their principal line of business would be reduced. This would have a very negative impact on the housing construction industry.

Like the commercial banking sector, but again, with greater severity, the quality of assets at savings banks and the availability of credit from these institutions to the Puerto Rican borrower would be affected by the overall deterioration of the local economy.

Securities Industry

Any reduction in the tax credit would negatively affect the 936 funds intermediated through the securities industry which amount to $2.5 billion. Here again, as the tax credit is reduced, these funds would be reduced substantially and, even in the event that the exemption on investment income would prevail, the reduction in the funds would make it academic. The ultimate impact would be in the reduced availability and higher cost of the capital needed to finance projects in Puerto Rico. These funds would have to be sought externally at a higher cost, assuming they were available.

During 1991 and 1992, 936 companies invested, through the securities industry institutions in Puerto Rico, $2.663 million in the following activities with maturities of five years or more:

Activities	Amount
Puerto Rico Government Bonds	$524 million
Mortgage Securities	$809 million
AFICA Bonds	$220 million
CARIFA	$517 million
Bank Securities	$443 million
Others	$150 million

Mortgage Banking

The financing of housing and commercial property would be directly affected with the reduced liquidity of the financial sector. Mortgage bankers account for 80% of the mortgages underwritten in Puerto Rico and most of them depend on the secondary market which is made possible by 936 funds. While these funds can be replaced by external sources, they would not be readily available and undoubtedly at a higher cost. This could mean that a good portion of the low income mortgage holders that qualify for loans underwritten today, probably would not qualify, due to a higher monthly payment.

On the other hand, federal agencies participate heavily in the Puerto Rican housing market either through direct loans, guarantees, or insurance underwriting. HUD, for one, has insured dwellings for $5.8 billion and the Veterans Administration has guaranteed mortgages for 1.2 billion dollars .

The majority of these loans are placed or sold in the secondary market through the use of Mortgage Backed Securities (MBO's) either through GNMA, if they are FHA or VA, or through FNMA or FreddieMac, if they are conventional conforming mortgages.

Non-conforming mortgages are placed in Collateralized Mortgage Obligations (CMO) which are sold to 936 companies. All of these investments would suffer as it is estimated that real estate values in Puerto Rico would be reduced by about 30% as a consequence of the recession that would follow the changes in Section 936.

HEALTH CARE INDUSTRY

For years, 936 companies have contributed significantly to the availability and quality of care in Puerto Rico. By providing one hundred and fifteen thousand

direct jobs, they also provide family health insurance to an equal number of families, covering a total of more than three hundred thousand people. These figures, important as they are, do not take into consideration the indirect jobs supported by the 936 companies which also generate health insurance coverage.

Any reduction in the jobs generated by 936 companies would then have an important impact on the quality of and access to health care. Some of these people would have to move to an already overburdened public health system which would be unable to accommodate them.

Access to health care would also be affected in the private sector which now depends, to a great extent, on health care plans. It is anticipated that some of these hospitals would be forced to reduce their services substantially or close down completely, particularly in those areas with a heavy 936 concentration. The effects trickle down to physicians offices, ambulatory care and other related health care services.

Consequently, the quality of care would also be negatively affected due to lesser technological advances, instrumentation, and the like, as income generation is reduced.

AGRICULTURE

The agricultural sector has been depressed in Puerto Rico for several years. However, since the advent of Section 936, and more recently, by the increased maturity of the investments made by these companies in our financial sector, credit has been more readily available to this important sector of our economy.

Agricultural lending is a required eligible activity to receive 936 funds (as per government Regulation 3582). This, not only has caused a more abundant availability of credit, but also a lower interest rate. The 936 funds has also stimulated new investment in the agricultural industry and the development of new projects.

This industry would be severely affected by a reduction in the pool of 936 funds that would send it back a number of years in its financial and productive capacity.

WHOLESALE AND RETAIL TRADE

The wholesale sector is mainly composed of distributors of US made and locally manufactured goods which depends on the economic well-being of our citizens. Here, again, financing is of outmost importance and the lower cost and better availability of credit afforded by 936 funds has allowed them to better finance their working capital and expansion needs.

The retail sector is mainly composed of individual proprietorships and small service organizations. It employs about 125,000 people which constitute a strong force in our economy and would suffer great hardship should the Puerto Rican economy experiment a setback. This sector lacks the capital necessary to finance its operations and expansions which has been supplied mainly by credit sourced by 936 funds. As a matter of fact, 65% of the commercial loans granted by the commercial banks in Puerto Rico are for amounts less than $25,000 and 90% are for amounts less than $100,000.

Finally, the municipal license tax that both wholesalers and retailers pay to the government, have been instrumental in the financing of government activities throughout the island.

CONSTRUCTION

Puerto Rico is in great need of developing a master plan for the rehabilitation and further construction of its infrastructure. The source of financing for these

projects, which include water treatment, energy generation, improvements to transportation ways, ports and airports, relies heavily on the low cost financing made possible by the 936 funds. Needless to say, the development of this infrastructure is vital to our economic development.

Private construction, like new housing, commercial and industrial buildings, would be reduced substantially should these funds not be available as readily as they are now, or at the low interest rates which they now command. The construction industry has a labor force of approximately 40,000 people, and a high employment multiplier because of its very nature. 936 companies, with their constant expansion program, have provided stability to this industry in the last decade. As a matter of fact, the industry estimates that 50% of the architects and engineers licensed in Puerto Rico depend on the 936-related construction work. With the constant menaces to Section 936, however, this activity has slowed down considerably as of late. Finally, housing construction, which is so vital for a community with a population density of 1,000 per square mile, would be greatly hindered. Many of the low income families that now are able to finance their dwellings would be driven out of the market.

The comments above reflect the importance of the 936 system to some of the sectors of our economy which are represented in this Coalition.

ATTACHMENT 2

MEMBERS OF THE PUERTO RICO PRIVATE SECTOR 936 COALITION

AIESEC - Puerto Rico
Asociación de Industriales de Puerto Rico
Asociación de Agencias de Cobro de Puerto Rico
Asociación de Agricultores
Asociación de Bancos de Ahorro
Asociación de Comerciantes de Materiales de Construcción
Asociación de Comerciantes del Viejo San Juan
Asociación de Compañías de Seguros
Asociación de Contratistas Generales
Asociación de Distribuidores de Automóviles
Asociación de Navieras de Puerto Rico
Asociación de Radiodifusores de Puerto Rico
Asociación MIDA
Asociación Puertorriqueña de Agencias de Viajes
Asociación Puertorriqueña de Representantes de Fábrica
Cámara de Comerciantes Mayoristas
Cámara de Comercio de Ponce y Sur de Puerto Rico
Cámara de Comercio del Oeste de Puerto Rico
Cámara Oficial Española de Comercio
Centro Unido de Detallistas
Colegio de Arquitectos de Puerto Rico
Colegio de Ingenieros y Agrimensores
Mortgage Bankers Association
Puerto Rico Bankers Association
Puerto Rico Hotel and Tourism Association
Sales & Marketing Executives
Securities Industry Association

Chairman ROSTENKOWSKI. Thank you.
Mr. Nordberg.

STATEMENT OF CARL A. NORDBERG, JR., COUNSEL, PUERTO RICO, U.S.A. FOUNDATION

Mr. NORDBERG. Good morning, Mr. Chairman.

I am Carl Nordberg, a member of the Washington law firm of Groom & Nordberg. I appear here today on behalf of the Puerto Rico, U.S.A. Foundation, which is a membership organization representing almost all of the 936 companies with operations in Puerto Rico.

As others have testified today, the administration's proposal is going to have a very serious and negative impact on Puerto Rico's manufacturing and financial sectors.

Shortly after the administration's proposal was made public, the member companies of our group who account for approximately 40 percent of the employment in the manufacturing sector of Puerto Rico responded to a survey. Admittedly, the survey is not a lengthy, precise study, but it does provide the only data available currently from the impacted companies.

In summary, the results of the survey are this: Of the companies surveyed, there would be a reduction in their current tax benefit of 72 percent; 76 percent of those companies said they would reduce their operations in Puerto Rico. Those reductions would result in a reduction in employment of approximately 28 percent; 75 percent of those companies had planned expansions in Puerto Rico, and now only 6 percent intend to follow through with those plans.

The survey reflects that the greatest impact will be on those firms in the chemical and instruments industries. Chemicals are basically pharmaceuticals, and the instruments are companies like Hewlett-Packard. The reduction in employment in chemicals will be 42 percent, and 18 percent in the instruments area. This is particularly significant data, because the chemical and the instrument industries are Puerto Rico's growth industries, both in terms of jobs and capital investment.

Over the past few years, these two industries have been responsible for 70 percent of the additional employment in the manufacturing sector, and 50 percent of the investment in fixed assets. Truly, as you have heard from other witnesses, these industries are the future of Puerto Rico. Based on the survey results, our economists project that overall employment in the manufacturing sector of Puerto Rico will steadily decline until 1998 when manufacturing employment will be down approximately 15 percent.

Let me put that in perspective. During the recent recession on the mainland, manufacturing employment declined 7.7 percent during the period 1989–92. Many Americans felt that impact, but the decline that we felt here in the United States of 7.7 percent is only one-half of the employment decline that Puerto Ricans will experience in the next few years under the administration's proposal.

Let's not forget where we begin. With 936 as it is, Puerto Rico's unemployment is currently 18 percent, more than twice the mainland rate. This sharp contraction in employment will have profound repercussions throughout Puerto Rico. It must be emphasized that there is nothing in the administration's proposal to offset the major

economic contraction that it will produce. The impact, therefore, on Puerto Rico will be severe and it will be permanent.

It is ironic that the administration's stimulus package proposes a $30 billion investment tax credit for jobs, at the same time that it would cut back on employment in Puerto Rico. Without a doubt, assuming the best results from the investment tax credit proposal, its impact on the mainland economy cannot begin to approach the relative adverse employment consequences that the 936 change will inflict on Puerto Rico.

Let's be clear: Puerto Rico has made great economic progress in the past 40 years, but the per capita income is less than one-third that of the mainland. As the Congresswoman who spoke first here today pointed out, if productive employment opportunities are not made available for the Puerto Rican people, their only alternative may be welfare or migration to the mainland. Either alternative will result in increased cost to the Federal Government.

Thank you, Mr. Chairman.

[The prepared statement follows:]

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HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS

ON

THE ADMINISTRATION'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

Statement
by
Carl A. Nordberg, Jr.
on behalf of the
Puerto Rico, USA Foundation

April 1, 1993

Mr. Chairman:

I am Carl A. Nordberg, Jr. and a member of the Washington law firm of Groom and Nordberg. I appear today on behalf of the Puerto Rico, USA Foundation, which is a membership organization representing a wide array of U.S. companies with operations in Puerto Rico.

Our membership includes mainland companies with operations in Puerto Rico that manufacture, among other products, electrical and electronic equipment, instruments, food and other consumer products, apparel, medical devices, and pharmaceuticals. As a group, our manufacturing member companies have operations in most parts of the world. In addition, our membership includes financial institutions, investment, accounting and other firms. Officials of the government of Puerto Rico are members of the Foundation's Board of Directors. The purpose of the Foundation is to inform U.S. policymakers of the importance of Section 936 to the people and economy of Puerto Rico; to the U.S. mainland; and, in particular, to the international competitiveness of the Section 936 parent companies and their hundreds of thousands of mainland employees.

Overview

We have asked for this opportunity to testify before the Committee to express our concern that the changes to Section 936 proposed by the Clinton Administration would have serious adverse consequences for the Puerto Rican economy. The proposal included in the Administration's package would limit the 936 credit to 65% of FUTA wages paid up to $57,600, effective for tax years beginning after 1993, with an election for 80% of the current credit in 1994, 60% in 1995, and 0% thereafter.

Even if for purposes of this debate one were to concede that it is possible for the U.S. Federal Government to meet its commitment to the Commonwealth of Puerto Rico with some revised package of economic development incentives, the current Administration proposal is flawed. Perhaps the most critical shortcoming is its failure to reflect an understanding that the current income-based 936 credit has been the basis of Puerto Rico's ability to develop a diversified economy. In the area of more specific criticisms, there is no recognition of the substantial non-wage compensation paid by the 936 companies to their employees. There is no recognition of the significant investments other than wages made by the 936 companies, such as capital investments and local purchases of materials and services. Nor is there any recognition of the considerable taxes paid to the Puerto Rico Government. Finally, the proposal ignores the critical relationship between the treatment the 936 companies receive for their Qualified Possessions Source Investment Income (QPSII) and the entire Puerto Rican financial system.

Disproportionate Impact

Perhaps even more troubling than our conceptual concerns with the proposal is the grossly disproportionate burden the Administration's deficit reduction proposal is placing on the already economically disadvantaged American citizens of Puerto Rico. This can be illustrated by the following simple analysis of the per capita impact of the revenue-raising provisions in the package.

The Treasury Department's estimates of the Clinton revenue-raising proposals project a revenue pick-up totaling $328.3 billion over the period FY 1993-98. Of this amount, it is estimated that $7.0 billion will be saved from the significant curtailment of the Section 936 tax incentive, which has been central to Puerto Rico's economic development.

There are 3.6 million U.S. citizens living in the Commonwealth of Puerto Rico and approximately 250 million citizens in the 50 states. Looking at the per capita impacts or "sacrifices" which the Clinton proposal imposes on Puerto Ricans, relative to other Americans, you get these results: Puerto Ricans are being asked to make a sacrifice amounting to nearly $2,000 per person. By contrast, mainland citizens are being asked to make a sacrifice of about $1,200 per person, or about $800 less per person than the Puerto Ricans, on an average basis.

The disparity of the impact of these proposals is wholly inequitable, particularly when one considers that Puerto Ricans have less than one-third the average income of mainland citizens, and less than one-half the income of the poorest State.

Moreover, 43% of Puerto Rican families have incomes less than $5,000 and over 95% of families have incomes of less than $25,000.

Critics of Section 936 erroneously argue that a reduction of Section 936 benefits will only affect the levels of profitability of certain corporations and will not adversely affect the average Puerto Rican. Such a conclusion is either uninformed, or simply erroneous. Data shows that for every $69 in tax benefits received by the pharmaceutical industry, for example, $100 flows back into the Puerto Rico economy through employee compensation, capital investment, purchases of materials and services and local taxes paid. For the non-pharmaceutical companies, the tax credit received for every $100 of Puerto Rican expenditures is only slightly less. As Section 936 tax benefits are curtailed, not only are jobs put at stake, but declining levels of income will erode payments for compensation, investment, purchases and taxes.

Survey of Impact of Administration's Proposal

The Administration's proposal will have a significant direct impact on possessions corporations' operations in Puerto Rico. Based on the recent survey of 50 PRUSA members from all segments of the manufacturing sector, the loss of Section 936 benefits that will occur will result in:

- Reductions in operations in Puerto Rico,
- Loss of existing jobs,
- Foregone potential employment gains, and
- Loss of QPSII assets

Members surveyed reported total 1992 Section 936 benefits of over $2 billion, employment of 42,000 and QPSII assets of nearly $9 billion.

Enactment of the Administration's proposal will reduce Section 936 benefits 72% and, as a result, three-fourths of the possessions corporations surveyed will reduce their operations in Puerto Rico. These reductions will eliminate 28% of the jobs now provided by these companies on the Island. Additionally, although nearly three-fourths of the corporations surveyed reported that they had plans for expanding their operations in Puerto Rico before the announcement of the Administration's proposal, now only 6% say they would expand if the proposal were enacted. Potential employment foregone because of the Administration's proposal would be equivalent to 10% of current employment, bringing total direct job losses to almost 40% of current employment at possessions corporations.

Employment losses will begin to occur almost immediately. By the end of the third year of the Administration's proposal, nearly 70 percent of the employment losses will have occurred.

Enactment of the Administration's proposal will also result in a significant reduction in QPSII assets. Survey respondents reported $8.8 billion of QPSII assets at the end of 1992. Sixty-nine percent, or more than $6 billion, would be withdrawn from Puerto Rico after enactment of the proposal.

Based on the Nathan Associates' survey, the Administration's proposal to change 936 will have the greatest adverse impact on 936 firms in two industries: Chemicals and Allied Products and Instruments and Related Products. If the Administration's

proposal were enacted, 936 firms in these two industries will, at minimum, make no new investment in Puerto Rico, and most will reduce substantially their level of economic activity and employment on the Island. More specifically, the following consequences are expected to occur in each industry:

	Chemicals	Instruments
	(all numbers expressed in percentage change in relation to 1992)	
o Loss of Section 936 benefits	77%	67%
o Possessions corporations that would reduce operations in Puerto Rico	84%	83%
o Job losses at possessions corporations	42%	18%
o Possessions corporations that had planned to make additional investments in Puerto Rico before the Administration's proposal	73%	86%
o Possessions corporations that would make additional investments in Puerto Rico if the Administration's proposal were enacted	0%	0%

Some argue that these consequences do not matter since the number of employees in these two industries are few (though, in fact, Chemicals and Instruments accounted for 26 percent of total manufacturing employment in Puerto Rico in 1991). But this misses the real significant employment contribution from these two industries.

- <u>Chemicals and Instruments are the employment growth industries in Puerto Rico</u>. Between 1984 and 1991, employment in Chemicals and Instruments increased by 10,171, representing 70% of total additional employment in the manufacturing sector. Employment increased by 41% in Chemicals and 27% in Instruments. In contrast, net employment gains for all manufacturing industries was only 1,334, or an increase of less than one percent.

- <u>Chemicals is the highest wage industry in Puerto Rico</u> at an hourly average earnings of $9.48. This is more than 50% higher than the average hourly earnings of $6.26 for all manufacturing industries. Instruments has the third highest at $6.75 per hour.

- <u>Chemicals and Instruments have experienced the largest gains in real net earnings between 1984 and 1991.</u> Net of inflation, earnings increased by 17.5% in Chemicals and 11.4% in Instruments, more than double the rate of increase in all manufacturing industries.

- <u>Chemicals and Instruments are the industries with the largest and most rapidly expanding investment in manufacturing.</u> It is universally accepted, and appropriately emphasized by President Clinton, that investment in plant and equipment is the key to

sustained economic growth and employment. In 1989, these two industries accounted for one-half on all depreciable (fixed) assets, and expanded at an annual rate of 17% compared to 10% for all other manufacturing industries.

o **Both industries have caused employment expansion in all sectors of Puerto Rico's economy through their indirect or multiplier effect.** Rapidly growing direct employment in these two industries has indisputably caused an increase in jobs in Puerto Rico in other non-936 manufacturing industries and other sectors.

What do these facts mean for Puerto Rico under the Administration's 936 proposal? The answer is unambiguous: the industries which have been the source of employment growth, gains in real earnings and expansion in investment (and offer the highest wages and opportunities for technological advance in Puerto Rico), will now be the industries of decline on the Island. The adverse economic impacts on Puerto Rico will be severe and permanent.

Role of 936 in Puerto Rican Economic Development

Since the Tax Reform Act of 1976, Congress has viewed the purpose of Section 936 as being to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations," thereby promoting economic development. The basic policy of Puerto Rico's "Operation Bootstrap," launched during the Truman Administration, and in which Section 936 has played a critical role, has been to move the economy from labor-intensive, low-skilled jobs, primarily in the agricultural and textile industries, to manufacturing, focused on technology-oriented companies. Moreover, the Island has been effectively foreclosed by economic realities and U.S. minimum wage laws from competing in the more labor-intensive low-wage industries. (Average annual wages in Puerto Rican industries are 4 times higher than in Mexico; 11 times higher than in the Dominican Republic, and 2 times higher than in Singapore, which offers equally generous tax incentives as provided in Puerto Rico.) Unfortunately, some of the critics of Section 936 are unaware of the level of economic development of Puerto Rico and the sophistication of its workforce, which far exceeds its neighboring Caribbean islands. In terms of productivity levels, Puerto Rico plants equal those that operate on the U.S. mainland.

It is important to note that even with the current income-based credit, Puerto Rico has found it increasingly difficult to attract investment and compete in the more labor-intensive, low-wage industries. While total manufacturing employment has remained relatively stable over the last 10 years, over 20,000 jobs have been lost due to the closing of plants. It is only due to the expansion of the high-tech, capital intensive industries, in the last 5-10 years that Puerto Rico has not suffered from an overall decline in manufacturing jobs. The Puerto Rico Planning Board estimates that 18,000 jobs were created by these industries between 1982-1989. The impact of the Administration's proposal will be most significant for the capital-intensive industries, which have been the source of the greatest expansion of highly-skilled and highly-paid jobs in recent years.

The importance of an income-based credit cannot be overemphasized. In a study cited last year by the Joint Committee on Taxation in connection with its examination of enterprise zones (JCS-12-92) it was recognized that narrowly targeting tax incentives may reduce the economic benefit below that which would be achieved with broad-based incentives. For example, an employment tax credit may skew the allocation of resources to labor-intensive industries. Similarly, tax incentives for capital may skew the allocation of resources to capital intensive industries. We most definitely agree with the study's conclusion that "a proposal which provides incentives of similar magnitudes for all types of capital and all types of labor is likely to result in larger economic benefit per dollar of revenue cost than more narrowly targeted incentives." In the case of Puerto Rico, we would argue that it is precisely because the possessions tax credit did not create a preference for labor intensive industries over more capital intensive and technologically oriented businesses that the 936 program has achieved such a high degree of economic benefit per dollar of revenue cost and has resulted in the creation of many highly-skilled, higher-paying jobs.

Impact on Puerto Rican Financial System

While the effect of the Administration's limitation on the Section 936 credit on Qualified Possessions Source Investment Income (QPSII) is not contemplated by its proposal, the impact on the financial system would be devastating. The banks in Puerto Rico stand to lose a substantial amount of their "936 funds", which account for approximately 35% of total deposits in the Puerto Rican financial system. Due to local Puerto Rican financial regulations, the $10 billion in "936 funds" deposits generate $12-$13 billion in economically productive, employment-generating investments and loans in Puerto Rico and throughout the Caribbean Basin. In addition, 936 companies directly hold investments of approximately $5 billion, consisting of Puerto Rican government securities, bonds, and residential mortgage obligations. A limitation on the 936 credit to 65% of wages would cause the 936 companies, to reduce their levels of income from Puerto Rico and thus reduce their 936 deposits in Puerto Rico's banking system.

Quality of Life

The improvement in Puerto Ricans' quality of life resulting from the economic development brought about by the island's industrialization has been nothing short of remarkable. Both absolutely and relative to the mainland, quality of life indicators such as mortality, life expectancy housing, education and literacy have all improved dramatically. Regardless of the measure chosen, the rate of quality of life improvement in Puerto Rico has exceeded the rate of the mainland. Today, general mortality (deaths per thousand of population) in Puerto Rico is lower than the mainland. Housing in Puerto Rico has improved more than any other measure; as recently as 1960 only 25% of year-round housing units had complete plumbing. By 1990, 87% had complete plumbing. Infant mortality, which in 1960 was as high as 43 deaths per 1000 live births in Puerto Rico has been reduced to 13 deaths per 1000. Today, the infant

mortality rate in Puerto Rico is closer to the infant mortality rate on the mainland (10 deaths per 1000) than any other time in history.

The level of education in the Puerto Rican population has increased dramatically as well. In 1970, only 18% of the 20-24 year-old age group were enrolled in post high school education programs. By 1990, over 60% of the same age group were staying in school. During the same time period, the percentage of college-level educated Puerto Rican workers has risen from 12% to 40%. These overall increases in the education level of the workforce correlate directly with the investment and expansion of the research intensive manufacturing industries, such as electronics, instruments, and health care, during the same time period. Not coincidentally, these industrial sectors provide the most highly-skilled, highest-paying jobs on the island. These statistics are the best evidence that young people stay in school when there is an opportunity to find skilled, high-paying jobs in expanding industries.

Factors such as the 936 companies' impact on the quality of life -- educational opportunities, health advances, increased disposable income and employment training -- while not a specifically designated statutory goal of section 936, nonetheless are significant factors which must be taken into account when evaluating the effectiveness of a program such as Section 936.

Mainland and Caribbean Benefits

Traditional analyses of the impact of Section 936 on the economic development of Puerto Rico have also ignored the substantial benefits to the U.S. mainland. Due largely to the operations of Section 936 companies in Puerto Rico, the island is now the world's 10th largest purchaser of goods, services, and raw materials from the U.S. mainland. In 1991, these purchases amounted to over $11 billion. The annual purchases by Puerto Rico from mainland suppliers supports approximately 220,000 mainland jobs. These figures are based on estimates made by the U.S. Special Trade Representative that 20,000 mainland jobs are created for each $1 billion of U.S. exports. A recent survey undertaken by PRUSA of 50 of its manufacturing member companies showed over $2.3 billion of goods and services were purchased by these 50 companies in 1991 from 46 states and the District of Columbia.

In addition, earnings of section 936 corporations repatriated to the mainland, which in recent years have ranged from $3 to $5 billion annually, help keep their parent companies competitive in the global economy, create increased mainland job opportunities, and contribute to research and development spending on the U.S. mainland. The U.S. maritime industry benefits as well, with over 25% of the value of all international shipments carried in U.S. flag vessels attributable to the trade between Puerto Rico and the U.S. mainland. And, the federal government benefits by having Puerto Ricans productively employed, thus reducing federal outlays for social welfare services.

Another positive aspect of Section 936 has been the incentive it has provided for U.S. multinationals to manufacture in the U.S. at a low enough cost to remain competitive for exports in world markets. As Congress attempts to balance our collective interest in reducing the

deficit, with our commitment to the U.S. citizens of Puerto Rico, we cannot afford to do anything that will discourage U.S. companies from remaining on U.S. territory and exporting rather than moving their operations abroad. No changes should be made to Section 936 that would reduce exports by encouraging companies to move manufacturing operations abroad; any new limitations should only apply to sales back to the mainland.

Other countries in the Caribbean and Central America have benefitted from the Section 936 program. Under the 936/CBI investment program initiated by changes in the 1986 Tax Reform Act, nearly $1 billion of Section 936 funds have been committed to private sector development projects in the Caribbean Region. These investments have or will generate over 28,000 new jobs. In addition, the availability of funding under this program has been primarily responsible for nine countries in the region entering into Tax Information Exchange Agreements with the U.S. government.

In asking Caribbean countries to execute TIEAs, the U.S. Government held out the promise and created the expectation that these countries could benefit from the availability of Section 936 funding. The Clinton Administration's effective elimination of funding for this program can only be viewed by our friends in the Caribbean as a unilateral reneging on this promise.

A particularly noteworthy aspect of the 936/CBI investment initiative has been the special program developed by the Section 936 corporations themselves. Caribbean Basin Partners for Progress (CBPP), a limited partnership of individual Section 936 companies, was established in 1991 for the purpose of channeling $100 million of investments into very small and medium-sized projects with high job-crating potential. Numerous small loans have already been placed by CBPP.

Multiplier Effect

Recent government studies of Section 936 have considered only its "tax cost per job." This approach, however, is faulty, incomplete, and misleading. First, it fails to consider how the loss of Section 936 would affect business decisions, profitability, economic activity, and tax collections in Puerto Rico and on the mainland. Second, it ignores the impact of Section 936 on long-run economic growth and improvements in the economic well-being of the people of Puerto Rico. Third, it ignores the relationships between the various industries and sectors of the Puerto Rican economy that together generate economic activity which far exceeds observed employment and wages for direct 936 manufacturing jobs.

Multiplier effects of economic activity, which provide a complete picture of the impact of specific projects, programs, and policies, have long been acknowledged and measured by the Bureau of Economic Analysis of the U.S. Department of Commerce. They consist of direct, indirect, and induced components. The direct impact is generated when an initial firm purchases the goods and services it requires to produce its output. These purchases are made usually from other firms within the same industry, as well as firms in other industries and household that supply labor services. The indirect impact is generated when the firms that sold goods and services to the initial firm purchase the goods and

services they require to produce the output they sold to the initial firm. The induced impact is generated when households spend some of their increased wage earnings from labor services they provided. Multipliers that are provided by the Bureau in regular publications measure for each state the total impact of goods and services produced, employment, and household earnings from labor services generated by 38 different industries across all sectors of the U.S. economy.

In Puerto Rico, the Government Planning Board estimates that 2.6 additional workers are employed for each worker employed in manufacturing: 1.13 are employed in industries supplying goods and services to the manufacturer and 1.47 are employed in industries producing the goods and services consumed by household from wage earnings. In a separate and independent analysis of multiplier effects of Puerto Rico manufacturing, the economic consulting firm of Nathan Associates has developed very similar job impact estimates. All estimates are fully consistent with widely recognized multipliers from the same industrial sectors on the mainland. The macroeconomic model of the Puerto Rican economy developed and used by the Congressional Budget Office also recognized and factored into its projections multiplier effects. Even the 1978 U.S. Treasury Department report on Section 936 recognized that for every $1.00 of compensation paid to section 936 manufacturing employees, an additional $2.59 of Puerto Rican goods and services were purchased. Despite these studies, and the universal acceptance of multiplier effects, the Treasury Department has refused more recently to measure and acknowledge the multiplier effects of Section 936 companies on the Puerto Rican economy. If such effects were officially measured, they would show that the actual "tax-cost-per-job" of Section 936 is less than it would cost the federal government to support an unemployed worker and their family through federal social welfare and transfer payments.

The 936 companies provide approximately 115,000 direct jobs to Puerto Rican workers. Based on the most conservative estimates of the multiplier effect, a total of at least 200,000 additional jobs are created in Puerto Rico's economy by these 936 companies' operations. Thus, nearly one-third of Puerto Rico's entire workforce consists of the 300,000 jobs generated by the Section 936 companies.

Non-Wage Expenditures

Traditionally, government economic analyses of the impact of Section 936 in Puerto Rico have also ignored the significant non-wage expenditures made in addition to the wages paid by 936 corporation for direct jobs. Indirect job creation and numerous other economic development factors are of equal, if not greater importance. Examples include compensation not included in payroll, purchases of Puerto Rican goods and services, investment in plant and equipment, and payment of Puerto Rican taxes. In addition the improvements in Puerto Rican and Caribbean infrastructure resulting from the availability of low-cost 936 financing have contributed to the economic advancement of Puerto Rico and the region.

Perhaps the best example of these expenditures is the previously mentioned study of the impact of expenditures by various industries on Puerto Rico. While a 1992 GAO study emphasized the tax benefit per job in the pharmaceutical industry, it ignored the fact that in general, total industry expenditures (for compensation; local purchases of materials, supplies and services; investments in plant and equipment; and local taxes paid) in Puerto Rico far exceed "tax

savings". Specifically, for every $69 of reported possessions tax credits for pharmaceutical companies, $100 of investments and expenditures were made by these companies in Puerto Rico. According to a recent survey by Price Waterhouse, the overall benefit to the Puerto Rican economy of pharmaceutical industry expenditures is 65% larger than the 936 benefits received by these corporations. Over the five-year period from 1986-1990, for every $100 of payroll in Puerto Rico, pharmaceutical companies on average made additional expenditures of $340 in Puerto Rico.

'Runaway Plant' Allegations

Contrary to what has been alleged by some critics, Section 936 has not induced an exodus of jobs from the mainland to Puerto Rico. Moreover, an examination of the three industrial sectors which have shown employment increases in Puerto Rico over the 20 year period, 1970-1990 -- pharmaceutical, electrical and electronic equipment, and instruments, -- show that each have had significant mainland employment increases during the same period. For example, while employment in Puerto Rico increased by 17,200 for pharmaceutical companies, total mainland employment increased by 89,000. While electrical and electronic equipment employment in Puerto Rico increased by 11,900, total mainland employment increased by 89,700. And, for instruments and related products, Puerto Rican employment increased by 10,600, while total mainland employment increased by 200,800.

There is further evidence to demonstrate the opportunity 936 provides to mainland firms to establish manufacturing facilities in Puerto Rico and produce competitively priced products has enhanced the number and quality of jobs on the mainland. The existence of these Puerto Rican manufacturing facilities is a significant factor in the generation of additional jobs on the mainland by keeping the parent companies competitive and economically viable.

Finally, it should be noted that in many instances, particularly in the case of pharmaceutical companies, products manufactured in Puerto Rico are new products. However, if for economic reasons a company determines it can no longer compete manufacturing a product on the mainland, runaway plant restrictions should not penalize companies for choosing to stay on U.S. territory and manufacture in Puerto Rico, instead of going to Mexico, or some tax haven such as Singapore.

Chairman ROSTENKOWSKI. Thank you, Mr. Nordberg.
Ambassador Bernal.

STATEMENT OF HIS EXCELLENCY RICHARD L. BERNAL, AMBASSADOR OF JAMAICA, CARIBBEAN BASIN INITIATIVE AMBASSADORS GROUP

Ambassador BERNAL. I am Ambassador Richard Bernal, Ambassador of Jamaica to the United States.

Mr. Chairman and distinguished members of the House Ways and Means Committee, I would like to thank you for the opportunity to appear before you today and to present the views of 10 sovereign Caribbean countries eligible to use 936 funds.

The eligible Caribbean countries are those countries which sign tax information and exchange agreements with the United States and are designated as qualified to participate in the Caribbean Basin Initiative. The 936 funds program and the Caribbean Basin Initiative are intimately linked and complementary.

The 10 countries are Barbados, which signed in 1984, Jamaica in 1986, Granada in 1987, Dominica in 1988, the Dominican Republic in 1989, Trinidad and Tobago in 1990, St. Lucia in 1991, Costa Rica in 1991, Honduras in 1991, and Guyana in 1992. Mr. Chairman, these tax information and exchange agreements were signed on the clear understanding that 936 funds would be available to the signatory countries.

I would like to say how pleased I am to be here appearing before this committee, because it was this committee which in 1986 approved the extension of 936 section to the Caribbean economies. I want to commend the committee, because the 936 program has worked very well and it is achieving the goals anticipated.

However, the task is not yet complete. The goals are, therefore, still valid. The 936 funds have provided significant financing for trade and investment in Puerto Rico, the Caribbean, and the United States. The financing of trade and investment has promoted growth in the United States, as well as in the Caribbean.

Mr. Chairman, I would like to point out the importance of 936 funds to expanding U.S.-Caribbean trade. By funding investment and trade, it stimulates production and exports and employment in the Caribbean, as well as in the United States. The growth of Caribbean economies provides an increasing export market for U.S. exports. Indeed, since 1983, U.S. exports to the region have increased by 65 percent, and if we calculate that in terms of jobs, this represents 80,000 new jobs.

Today, U.S. exports to the CBI region are calling for $10 billion of exports, representing 200,000 jobs in the United States. In addition, trade with the CBI region is one in which the United States has a favorable trade balance and one which has grown. In addition to this, Caribbean economies spend a large share of their export earnings purchasing goods from the United States than any other region in the world—60 cents of every U.S. dollar earned is spent purchasing goods and services from the United States. This compares with 10 cents of every $1 for Asia.

Mr. Chairman, on behalf of the 10 eligible countries, I would like to emphasize how important the 936 funds are to promoting eco-

nomic development in the Caribbean. There are seven specific ways in which this assists economic development in the Caribbean.

First of all, it increases investment. Today, the 936 funds are the largest single source of capital inflows into the beneficiary countries. In fact, it now represents 23 percent of total capital inflows.

Second, these funds have been used to modernize infrastructure and telecommunications, particularly in Jamaica, Barbados, Trinidad, and Granada.

Third, it has funded privatization, particularly of hotels in Jamaica.

Fourth, it has served to increase foreign exchange earnings of these economies, which is critical to their growth process. It has increased foreign exchange earnings in two ways, directly as an inflow and has helped to stabilize the exchange rate of these countries, but, second, these funds are invested in productive capacity for export and, therefore, increase the export earnings of Caribbean countries. We have seen this in bauxite and aluminum in Jamaica, bananas in Costa Rica, Honduras, and in Dominica.

Fifth, it serves to expand food production in these countries, both for domestic consumption and for export.

Sixth, it has an important employment creation effect. This employment creation takes place both in the Caribbean and in the United States, and we should note that job creation in the Caribbean serves to reduce migration of Caribbean people to the United States. The CBI region is the largest source of migrants to the United States.

In addition to this, we need to note that the jobs created in the Caribbean are not at the expense of jobs in the United States. They are complementary. For example, garment production in the CBI, the finished product has 80 percent U.S. input in terms of raw material and machinery. Therefore, job creation in the Caribbean is complementary to job creation in the United States

Seventh, the economic development generated by 936 funds serves to stabilize democracy and promote social stability in the Caribbean and to reduce the vulnerability of these countries to drug trafficking.

In closing, Mr. Chairman, the 10 eligible Caribbean countries recommend the retention of the 936 section of the Internal Revenue Code, without modification. We recommend this, because it is working well. It is an essential part of the economic development of the Caribbean. This development contributes significantly to the growth of trade, employment, and investment for the U.S. economy. It would be a pity if this program was to be changed, because it would have an adverse impact and would serve to change the context in which Caribbean economies have operated in their economic relations with the United States.

Thank you, Mr. Chairman.

[The prepared statement and attachment follow:]

THE ROLE OF 936 FUNDS IN ECONOMIC DEVELOPMENT OF CARIBBEAN COUNTRIES

Statement by Dr. Richard L. Bernal
Ambassador of Jamaica to the United States of America

At the Hearing before the U.S. House Ways and Means Committee

April 1, 1993

Mr. Chairman and distinguished Members of the House Ways and Means Committee, I would like to thank you for the opportunity to appear before you today and to present the views of the Caribbean countries eligible to use 936 funds. It is a pleasure and honor to be able to appear before you today to speak about the Section 936 program and its relation to the Caribbean. Indeed, this forum is especially welcome because the amendment to the Section 936 program -- which created the opportunity to use section 936 funds for Caribbean financing -- was initiated by this Committee in the Tax Reform Act of 1986.

Seven years later, we can see clearly that this amendment has worked very well. The Section 936 program has made a significant contribution to the economic development of the entire Caribbean basin and to the United States by providing financing to facilitate increased trade and investment. Originally envisioned as a tax provision designed to encourage U.S. firms to invest in Puerto Rico, specifically in manufacturing, the program has now become a major source of financing for projects throughout the Caribbean. Section 936 of the Internal Revenue Code allows funds to be invested in eligible Caribbean countries, i.e. countries which have a Tax Information and Exchange Agreement with the United States and are designated as qualified to participate in the Caribbean Basin Initiative. To date, the following countries have signed Tax Information Exchange Agreements: Barbados (1984), Jamaica (1986), Grenada (1987), Dominica (1988), Dominican Republic (1989) Trinidad and Tobago (1990), St. Lucia (1991), Costa Rica (1991), Honduras (1991), Guyana (1992). At the time these agreements were signed, the understanding was that 936 funds would be available for investments in the Caribbean. These tax agreements commit signatories to cooperate in sharing tax information with the United States, which is an important mechanism to fight money laundering and prevent U.S. tax evasion.

Overall, the impact of this provision has been considerable, as it has resulted in increased U.S.-Caribbean trade and investment and promoted economic growth and employment in both the United States and the Caribbean countries. The impact of this tax provision resulting from investment and trade has been considerable.

A. EXPANDS U.S-CARIBBEAN TRADE

Section 936 financed projects have expanded trade between the Caribbean and the United States by promoting investment, increasing production, exports, and economic growth. Given that Caribbean economies do not have a capacity to produce capital goods, investments require imports, approximately 70% of which are supplied by U.S. firms. As Caribbean countries experience growth and expansion, new opportunities for investment and trade are created for the United States.

Since the Caribbean Basin Economic Recovery Act (CBERA) was enacted in 1984, the U.S. has developed a growing trade surplus with CBI countries: from 1983 to 1990 U.S. imports from the region declined by 15.6% while U.S. exports to the region increased by 64.7% from $5.7 to $9.7 billion. Given that US$1 billion of U.S. exports to Latin America generates 20,000 new direct jobs in the U.S. The increase in CBI purchases of U.S. goods and services from 1983 to 1990 helped to create 80,000 new direct jobs in the U.S. Of every U.S. dollar of foreign exchange earnings by the Central American and Caribbean countries, 60 cents is used to buy American products, as compared to Asia which spends only 10 cents.

B. PROMOTES CARIBBEAN DEVELOPMENT

As the Caribbean economies undergo major economic changes and adopt private-sector led, export-oriented growth policies, the availability of funds for investment becomes acute. Countries in the Caribbean have been able to draw on this pool of capital, to promote growth through the expansion of private investment and to finance critical public sector development projects. Section 936 financing has helped to strengthen the economies of each of the eligible Caribbean basin countries. Section 936 funds have financed investments, which have been critical in the creation of jobs, the installation of productive capacity, and the production of goods and services. The specific ways in which 936 funds contribute to Caribbean development and thereby increase U.S.-Caribbean trade are:-

1. INCREASES INVESTMENT

Several Caribbean Governments have implemented comprehensive economic reform programs which involved the removal of all barriers and impediments to the operation of the market. This has resulted in the creation of a private-sector led, market driven economy. The process of accelerating and sustaining economic growth depends critically on the volume of investments in both public and private

sectors. Section 936 funds have been important in funding public sector development projects and private sector investments since 1988, see Table 1. These funds have been particularly valuable because they are available in foreign exchange and therefore alleviate the foreign exchange constraint as well as expands the volume of investment. As Table 2 shows, 936 funds were the largest source of capital inflows in TIEA signatory countries, in 1991, accounting for 23.3 percent of total inflows.

These flows have been particularly important, given the reduced U.S. aid (development assistance and economic support funds) allocated to several Caribbean countries since the mid-1980s. In 1984, the Eastern Caribbean received US$104.6 million, but in 1992 this was US$21.7 million, a decline of 79.3 percent. In Jamaica, the amount was US$155.3 million in 1985, but fell to $68.8 million in 1992 a reduction of 55.7 percent. The inflow of 936 funds has offset the decline in US aid flows.

2. BUILDS INFRASTRUCTURE

The resources provided by 936 funds have made a substantial contribution to the rehabilitation and upgrading of infrastructure, which complements and enhances the efficiency and productivity of private investments, as well as improves export competitiveness. For example, the trans-Caribbean telephone cable project financed through Section 936 funds will enhance the region's communication links and provide the countries with state-of-the-art service and equipment.

To compete effectively in today's global economy, modern transportation and telecommunication are essential. Air Jamaica received $51 million in 936 funds to acquire two aircraft which it now uses on high density flights to and from the United States. A phone cable project that improves telecommunications services in Jamaica and expands the volume of international calls that can be dialed directly from the island was also financed through 936 funds. In Barbados, a total of US$35 million was spent to expand and upgrade infrastructure of the Barbados Telephone Company while Grenada Telecommunications Limited benefited from US$8 million, which was used in the expansion and upgrading of their facilities and equipment. Trinidad and Tobago received a total of US$210 million which was spent on infrastructure for natural gas exploration and construction of petroleum facility to separate butane and methane from natural gas, as well as a water flooding project.

3. PRIVATIZATION OF PUBLIC ENTERPRISES

Money from this program has helped to fund privatization programs, which reduced the drain of fiscal resources to public

enterprises and transferred assets to the private sector. Hotel privatization programs such as the Wyndham Rose Hall in Jamaica, led to more efficient management, expanded employment and significantly increased revenue generated by that property.

4. INCREASES FOREIGN EXCHANGE EARNINGS

The 936 funds have provided foreign exchange inflow which has helped to stabilize the exchange rate and to generate additional foreign exchange earnings by expanding export capacity in the bauxite/alumina industry, in Jamaica, and improving the plant and efficiency of the tourist sector e.g. the refurbishing of Mallards Beach and Americana Hotels in Ocho Rios, Jamaica, refurbishing of Hotel Embajador and construction of Fiesta Bavaro Hotel, in the Dominican Republic. The wood and sugar processing industries in Honduras also benefitted from the 936 funding.

5. EXPANSION OF FOOD SUPPLY

The agricultural sector has been able to utilize 936 funds to expand its productive capacity e.g. expansion and modernization of broiler meat and hatching egg facilities, in Jamaica; development of banana plantations and related facilities in Costa Rica; establishment of a cardboard box factory in Dominica to supply that country's banana industry and manufacturing sector at a cost of $2.1 million.

6. EMPLOYMENT CREATION

The projects financed with 936 funds both in the public and private sector have directly, and through their multiplier effects, created thousands of new jobs across a range of skill categories. Job creation discourages legal and illegal emigration. Migration movements from the Caribbean and Central America have intensified in the last decade. From 1981 to 1988, emigration from Central America and the Caribbean to the United States amounted to 47 percent of total emigration into he United States.

The jobs created by investments, funded by 936 funds, are not at the expense of jobs in the United States. In fact, production and employment in the Caribbean and the United States are complementary. For example, the production of apparel in the CBI region is complementary to production in the United States. Of the apparel produced in Jamaica, 80 percent of the finished goods consist of U.S. raw material, machinery, and other inputs, most of which is made for U.S. firms. Without this complementarity of production between the U.S. and CBI countries, U.S. firms and Caribbean producers would not be able to maintain their market share or their competitiveness in the global market place.

7. DEMOCRACY AND SOCIAL STABILITY

Economic development is a necessary, but not sufficient condition to ensure democracy. Since development is the foundation on which enduring democracy can be built and maintained, U.S. foreign policy must aim at supporting economic development in the Caribbean as the basis for political stability and democracy in the region. These small countries are very vulnerable to narcotics and drug trafficking. Therefore, vigorous anti-drug trafficking programs will have to be pursued nationally and regionally. While focusing on destruction of crops and processing facilities, interdiction, public education, and against money laundering, more attention and resources must be devoted to providing jobs and economic activity as an alternative to involvement in drug trafficking. In Jamaica, through the 936 program, the construction of 750 low-cost prefabricated housing units, which were manufactured in Puerto Rico and assembled and installed in Jamaica, added significantly to the housing stock, from which the lower income earner benefitted.

RECOMMENDATIONS

Section 936 has operated according to the original intent of the U.S. Congress and has brought about the desired results and its place in Caribbean development has grown more prominent and important each year. It is an essential program without which many important projects throughout the Caribbean would not have been realized.

The countries which have signed TIEA's recommend the retention, without modification, of the Section 936 tax incentive because the availability of Section 936 funds provide an invaluable source of financing for investments in the Caribbean economies and trade between the United States and the Caribbean. The development of the Caribbean economies and the other economies in the region contribute to the economic growth of everyone in the region, including the United States.

Changes in the tax incentive structure to the Section 936 of the Internal Revenue Code would adversely impact on investment and growth in the Caribbean and on U.S. exports and employment.

TABLE I

USE OF 936 FUNDS BY CBI COUNTRIES
Calendar Years 1988 - 1992
Millions of Dollars

	Disbursed	Pending	Total
Jamaica	275.1	60.0	336.1
Trinidad and Tobago	210.0	124.0	334.0
Dominican Republic	77.6	5.0	82.6
Costa Rica	52.7	5.2	57.9
Barbados	36.2	-	36.2
Grenada	8.0	-	8.0
Honduras	2.9	0.9	3.9
Dominica	2.2	0.5	2.7
Guyana		0.6	0.6
Total	665.8	196.3	862.1

TABLE 2

TOTAL LOANS DISBURSED BY FINANCIAL SOURCES
IN TIEA SIGNATORY COUNTRIES
DURING 1991

Millions of Dollars

Inter-American Investment Corporation	3.0
German Investment & Development Company	3.3
International Finance Corporation	20.1
Overseas Private Investment Corporation	22.8
Caribbean Development Bank	27.4
Business Advisory Services	37.2
International Development Association	50.7
European Investment Bank	71.9
Commonwealth Development Corporation	75.9
Overseas Economic Corporation Fund	94.9
International Bank of Development and Reconstruction	161.2
Inter-American Development Bank	201.9
Sub-total	770.3
SECTION 936	233.4
Total	1003.7

Mr. RANGEL [presiding]. Thank you.

I think that is the entire panel. Ambassador Bernal, I am really embarrassed to see that a recommendation could be made to raise revenue to decrease our deficit that could cause adverse economic effect to so many countries that have been so friendly to the United States. But I am especially embarrassed, because I have lived through the improved relationship that we have had. I know the efforts that have been made by these small countries with fragile economies to try to make the Caribbean Basin Initiative work.

I also know what you have done to support our efforts to make the 936 program work for us and to work for you. I know the embarrassment and sometimes the loss of national pride to get your governments to sign tax information exchange agreements. But you have done all of these things, and now it looks as though with one stroke of the pen, we are saying all bets are off.

Well, you are not citizens of the United States and, quite frankly, I don't know what to tell you to do. It appears to me to be arrogant just to suggest this, without hearings, without studying what adverse economic effect this is going to have.

I can only tell you that whatever diplomatic sources that you have at your disposal, if you want us to help you, you will have to use those diplomatic vehicles that you have available. This I think strikes at all the Caribbean countries, especially Jamaica, who has provided the leadership and the assistance of your sister countries in the region to show that it can and should work. All I can say is that I am embarrassed.

To my fellow citizens from Puerto Rico, however, there is a difference, because while it may appear at times that you are being treated as a foreign country, it shocks and amazes me how one-third of your jobs are dependent on a tax program that is completely at the whim of Presidents and Congress, and when the popularity of pharmaceuticals are falling down below the popularity of even Members of Congress, we are now prepared to say we will get even and hit them with a $8 billion tag, notwithstanding the impact it is going to have on our citizens in Puerto Rico.

What amazes me is the lack of outrage. Do you really think you, Mr. Colorado, born in New York City, attended Harvard, do you really think any other group of U.S. citizens would be treated this way? Do you really think that for $7 billion, we will shoot crap at the jobs of people who are American citizens, not even knowing whether we will pay—forgetting the pain and the discomfort and the embarrassment—the cost of having these people dislocated? Can you imagine this happening to any other group of U.S. citizens?

Of course, for the American businessmen, there were tones, Mr. Carrion, in your language about what is going to be insisted upon. Insisted how? What are you going to do about it? The President has spoken.

I would suggest that if there is any feeling of discomfort, that someone should write the President of the United States in English and in Spanish and indicate that, under our Constitution, you should be treated at least fairly. It doesn't matter to this member one way or the other whether we have 936, as long as there is some way to be assured that the people who have the highest un-

employment, the highest mortality rates, the highest poverty, are now being asked to make further sacrifices.

If you are going to wipe out 936, for God's sake, have hearings, have a transition, have a substitute and have something that is either as good or better. You have heard the chairman say that we are now going to have to find $7 billion. So you are citizens, you find the $7 billion somewhere.

I would suggest that whether we are talking commonwealth, independence, statehood, that this may be the best thing that has ever happened to the Puerto Rican people. They have really tested now the citizenship that you have. And as far as this member is concerned, we are saying we don't know whether wage credit works or whether it does not work. All we know is we need the money, and you are a long way from the mainland and somehow you will survive.

Mr. Colorado, what are you going to do next?

Mr. COLORADO. We have two alternatives, either to convince the people who have to make the decisions that the decision is wrong, or to wait and see and then I wish I didn't have to say "I told you so." But there are no funds that are going to come into the Treasury.

The funds that are going to leave the Treasury to pay for a job creating program, which for 50 years has been much more effective cost-wise than the one that the President is proposing right now. I mean, our cost per job is less than one-half that of the jobs that the President is proposing at this time. So I think we have those two alternatives right now, either convince, from the President down, everyone who has anything to do with this, with what is true, what is right, with what is fair for Puerto Rico, or else wait and see.

I have to tell you that, under the other status alternatives, we would not be discussing this issue. We probably would have more power in some other area, but there would be no 936, anyway.

Mr. RANGEL. Mayor Acevedo.

Mayor ACEVEDO. I think we first have to state here, and I have been working with people in the White House and the Treasury Department, that this is very unfair, because you cannot ask for the poor people to pay more than twice the other people. Second, this is mortgaging our future of creating employment for our people.

So our mission first has to be to create, to give you the facts, as the decision-makers, the fact that you are really hurting people who want to work. Second, the alternative being proposed is proposed for a market that is not there, because the wage credit proposal is not as attractive as the 936 proposal, and we have been losing jobs in the labor-intensive industries with 936.

Mr. RANGEL. Let me interrupt and try to suggest to you that you not wait until you persuade this committee or this Congress that this is the wrong thing to do. Because we may sympathize with you, but if we have to find $7 billion, believe me, we all have congressional districts and it is whose ox is going to be gored.

I would suggest that you try to have this change made before this issue reaches the Congress. Let the President swallow this $7 billion. And I say to my Ambassador from Jamaica, you get in

touch with the State Department and the executive branch and have it be known there.

I would like to say, too, for those who think that this is going to bring you closer to statehood, I am writing a book as to the hurdles you have got before you become a State, so I don't want anyone to believe that 936 is an impediment.

But I strongly suggest to you not to depend on this Congress to bail you out. It would seem to me that the President of the United States has the responsibility for all of our American citizens, with or without the vote in the Congress, and I think that is where you should really concentrate your efforts, to see that we don't have that choice to be made here. Because if you leave it up to us and give us the pharmaceuticals, believe me, politically speaking, it doesn't look that good.

But I think the President is a compassionate man, a sensitive man. I think he has been given some bad information, and if you have the opportunity to share with him the impact that it could have on citizens in Puerto Rico, I am certain that he would be sensitive enough to review his decision and make it easier for us here in the Congress.

Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

As usual, my friend Charlie Rangel's pragmatism and common sense comes through loud and clear. I must add, however, from a slightly different perspective, that over the last four years we had a caring and sensitive President. This committee very rarely did whatever he asked. So this committee has the opportunity to chart an independent course and has proved that year after year after year.

I would like to ask you some specific questions. Perhaps this has come through in some of your testimony, but I would like it repeated, so that it will be for certain indelibly in the minds of our citizens in this country. How many jobs do you estimate will be lost in Puerto Rico in the next 5 years as a result of the change proposed by President Clinton?

Mr. COLORADO. Congressman, it is very hard to determine the exact amount. The companies have said that there could be a loss of 28 percent of what they represent. What I can assure you is that we lost, for example, in the last 10 years 11,000 low-technology jobs. There is no reason why we will not continue to lose that type of job to Mexico, to Central America, to other countries, to Asia. We will continue to lose the jobs that cannot pay any more than $1.50, $2.50, and in Puerto Rico they pay over $4. So we will lose those jobs.

For example, we lost 5,000 jobs in the tuna canning operation in the last 3 years. We have 5,000 left that we will probably lose pretty soon. So we are going to continue to lose the low-technology jobs.

Now, the high-technology jobs, it is a matter of numbers. It is not just a matter of saying are they going to leave or not. If they are going to pay for that extra dollar in Puerto Rico, more taxes than they would pay in the United States, they will not stay. But not only will they not stay, it won't make any sense for new industry to come to Puerto Rico, if they are going to end up paying taxes in Puerto Rico on that marginal dollar, on the extra dollar which

is higher than those that they will pay in the States or in Ireland or in Singapore or in Mexico or any other country. It is very difficult, but I can assure you the trend will be negative.

Mr. ARCHER. If you can develop some information as to the projected number of jobs that would be lost as a direct result of this proposed change, we would appreciate having them in writing and submitted to the committee.

Mr. COLORADO. We will do that, sir.

Mr. NORDBERG. Mr. Archer, in my testimony I pointed out that, based on the survey of the 936 companies down there, and we represent most of them, if this proposal was adopted, in the next 5 years the reduction in jobs in the manufacturing sector in Puerto Rico would be somewhere in the range of about 15 percent. Sometimes when you talk in terms of numbers of jobs in Puerto Rico, it isn't as impressive as it is to the people in Puerto Rico, because you all are used to working with such large numbers.

But if you think about it, as I mentioned in my testimony, a 15 percent reduction in the manufacturing sector in Puerto Rico, that is twice the impact and the reduction we had in the recent recession in the United States, and we all thought that was pretty bad. Puerto Ricans are being asked to take a 15 percent hit, and they are already starting with an 18 percent unemployment rate.

Mr. ARCHER. Just following up, which industry, in the opinion of you gentlemen, would benefit the most from the proposal made by the President?

Mr. COLORADO. Congressman, no industry will benefit. No industry will benefit, because the low-technology industry, which we are losing anyway, is going to have exactly the same benefits it has now, so it is a reduction in benefits for the rest of the industry, but no one is going to be better.

Mr. ARCHER. So there will be no winner, not one single winner that you can think of——

Mr. COLORADO. No.

Mr. ARCHER [continuing]. But a lot of losers, as I hear your testimony.

Thank you very much.

Mr. RANGEL. Mr. Pickle?

Mr. PICKLE. Thank you, Mr. Chairman.

I am pleased to see such a large and spirited group as testifies here this morning, as well as the large number who have come here to hear the testimony. One of the staff people recommended to me that this ought to be titled "A Case of Life, Liberty and the Pursuit of 936 Funds." [Laughter.]

I am sure there is not a selfish ounce of blood in any of you people out here testifying, ounce of selfishness I mean on this program.

Let me start off by saying to you that we are trying to find an answer for this program and the Congress has been concerned about it for many years. This is not a jumped up ad hoc hearing. This question has been going on for many years, and you know it and I know it, and we have got to try to find some kind of an answer to it.

I think it is not unprecedented to say to this committee that we ought to recognize what is involved here. Today, approximately $10

to $12 billion of section 936 funds are on deposit now, and 80 to 90 percent of that is in the private banks, I think primarily Chase Manhattan and Citibank. The rest of it, 10 percent, is on deposit in the state banks of Puerto Rico. That money is not being taxed by Puerto Rico, and if it is kept there for 5 years, it comes back to the United States tax-free.

There is this rolling sort of deposit and reinvestment or rollback to the United States, and so the sum will probably stay somewhere around $10 to $12 billion. That is a pretty good sum of money for any possession or any State or any entity to have to operate with.

Now, I can see why you want to defend that. All the President has done is recommend that, instead of making it income based, we make it wage credit, and you said we might lose some jobs. The question is not about whether it loses you jobs, particularly, but about fairness about the investment of these funds.

So as we say we have got to protect each of your industries, we have got to also think what happens to the United States. All the President recommended is to base section 936 on wages, instead of income.

Now, I want to ask some questions, and I am not trying to be prejudiced about it, but I think it is time to just get down to some basics, instead of speechifying. Let me ask you a couple of questions.

In 1986, we preserved section 936 funds, and at that time we said that if Puerto Rico actually invests up to $100 million in 936 funds in other CBI countries, we will keep this program like it is. At that time, it was my judgment that you were close to losing that big credit, and so you adjusted quickly to say yes, you would accept that program.

Initially, you fought it because that was just an intrusion on your rights, we shouldn't do it. And the Congress had, by statute, our subcommittee said you have got to invest the money better rather than just keeping it on deposit in private banks or state banks, and so you agreed to that.

Some of you, particularly Mr. Colorado, know that you have done well with that, and this member of the committee says you have. You have met your $100 million investment in the CBI program each of the last 4 years. You have gone from $100 million maybe up to $200 million, so that is commendable and that is putting your money to work in helping the CBI countries.

So I don't take that as being negative. But I also say to you that amount of money, $100 million or $200 million, is 2 or 3 percent of the moneys invested down there. So I have to ask myself, that is some help, but how much is it, really?

Now, if you were to do away with this 936 loan program and replace it with wage credit, what would happen to the 936 CBI program?

Mr. COLORADO. It would be lost, Congressman. It would be lost, because there would be no incentive in generating more profit in Puerto Rico than that which is necessary for you to cover your credit. If your credit is depleted——

Mr. PICKLE. Do you all agree that it would be lost?

Mr. NORDBERG. Yes, sir.

Mr. PICKLE. I am not surprised, but I want to make it a matter of record.

Now, let us say we were to replace 936 funds with the wage credit. Some of the 936 companies have gone to Puerto Rico and have made investments of millions of dollars. Would they close up their Puerto Rican operations and walk away, if we were to go to wage credits?

Mr. COLORADO. Some of them will.

Mr. PICKLE. Do you all generally agree with that, some of them or most of them?

Mr. NORDBERG. Some will.

Mr. PICKLE. Some, not all, but just some.

Mr. NORDBERG. Some.

Mr. COLORADO. Not only that, Congressman, but it would be——

Mr. PICKLE. By some, 5 percent of them or 10 percent or half of them, or what?

Mayor ACEVEDO. May I respond to that, Congressman? I presented a table of what has happened in the last 10 years with that type of employment in Puerto Rico. The tendency with the wage credit will be to favor the labor-intensive industries. That industry will have lost about 11,000 jobs with 936 and we will continue losing that type of jobs, because of the competition. We have been substituting that loss of jobs with high-technology jobs. If this is taken out, then we will continue losing, without winning for anyone.

Mr. PICKLE. You have testified that some of them would leave. You don't tell me how many, but some would leave. Some of them or a good many of them may come to the United States.

Mr. NORDBERG. Mr. Pickle, when I said some——

Mr. COLORADO. They are in the United States, Congressman.

Mr. NORDBERG. When I said some, Mr. Pickle, in my testimony I pointed out that we checked with our companies after the proposal came out, and 76 percent of those companies say they will reduce their operations in Puerto Rico. You asked a somewhat different question as to whether they would leave or not. But a large proportion of them are going to reduce their operations in Puerto Rico, and the jobs impact is going to be a reduction of at least 28 percent. That is a very significant number for Puerto Rico.

Mr. PICKLE. Let's accept 28 percent. I am not trying to nail a figure down. But we know that some of them would leave, some of them might even come back to the United States, but there will be some changes down there.

Now, the President is not recommending the elimination of 936 section. He is just simply saying that the tax credit is going to be based on the wage credit approach, rather than on an income basis, and that is all he is going to do.

Now, I have the feeling, based on the studies I have looked at, that the 936 funds have not created a lot of new jobs. The job level has been reached and then has leveled off. It has not grown a great deal.

Mr. COLORADO. It has, Congressman. Let me explain something which I think is very important. When you are capable of exchanging 11,000 jobs of low-technology industry for 11,000 jobs of high-technology industry, something is working very, very well. I think this is important to realize, that we have been losing those jobs,

that we cannot compete any more, and we have been able to establish jobs. To establish one high-technology job for each low-technology jobs that you lose is very hard, and we have been able to do so. We have been capable of doing that with a multiplier effect that has created more jobs.

Mr. PICKLE. Mr. Colorado, all the President is recommending is that whatever wages you have, 65 percent of them would be given credit, and that is an incentive for jobs.

Mr. COLORADO. But it will not work.

Mr. PICKLE. There might be some change on it, but to say it will devastate Puerto Rico, it seems to me a little bit far-fetched.

Mr. Chairman, I know that my time is expired and I know that other members want to ask questions. I would like to come back on a second round, if I may.

Mr. RANGEL. Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman.

I find myself in a rather strange position. I do not believe in the President's economic program, and yet in a way I understand what he is trying to arrive at. Let me give you an example.

There was a GAO report, which I am sure you have seen, that was done in May 1992, talking about the tax benefits of operating in Puerto Rico, particularly for the pharmaceutical industry.

But let me ask you a question: Suppose there was an island off Puerto Rico and the average worker was being paid, let us say, between $15,000 and $20,000 However, there was a tax credit for over $70,000 per worker being given to that island and it was taking employment away from you. How would you feel about it? That is what the President is facing in terms of the statistics which come out of this report.

Mr. COLORADO. Congressman, what do you mean by taking jobs away from you when this is part of the United States? We are talking about the United States. We are talking about jobs being created within the United States. We are talking about jobs which have a multiplier effect on the mainland, which have generated more than 300,000 jobs here in the mainland because of our program in Puerto Rico. If those companies would go to Singapore or Asia, you wouldn't have any jobs.

Mr. HOUGHTON. I understand that. I am not talking about that. I am talking about other parts of the United States. On top of the patent protections and research and development tax credits, federally funded NIH deductions that drug companies routinely take advantage of, there is about a $71,000-per-employee tax break for each particular job there.

Now, is that necessary?

Mr. COLORADO. Congressman, 8 years ago we were here, and 3 years before that, we were also here. The allocation of those intangibles was made. And those companies, though people don't realize it, pay taxes in the United States on 50 percent of their income generated in Puerto Rico under the profit split method. These companies, on 50 percent of their total profits on the products manufactured in Puerto Rico pay full U.S. taxes; and then on the other half, they pay the lower Puerto Rican taxes. So these companies are not exempt on their profits from Puerto Rico.

Now, they could be doing that somewhere else and having the same profits.

Mr. HOUGHTON. Right. But if a company moves to Puerto Rico from the mainland, mainly because it gets this particular tax credit, that is an unusually high tax credit now, isn't it?

Mr. COLORADO. That is very unusual to happen because we don't know of many companies that have closed their operations and opened operations in Puerto Rico. As a matter of fact, we do know of how many jobs we generate in the mainland because of Puerto Rican operations.

Mr. HOUGHTON. Well, there are lots of other questions that I could ask here, but won't. I don't want to hurt Puerto Rico. Puerto Rico is an enormous part of this country. I am looking at the inequities here in terms of some of these tax breaks.

I am all through, Mr. Chairman.

Mr. RANGEL. Mr. Hoagland, do you have any questions?

Mr. HOAGLAND. No. I will pass, Mr. Chairman. Thank you.

Mr. RANGEL. Mr. Brewster.

Mr. BREWSTER. Thank you, Mr. Chairman.

Earlier today, Congresswoman Velázquez testified here—and I think all of you were in the audience—and one of my colleagues asked how she would plan that Puerto Rico shared in the sacrifice, because in her testimony she mentioned that Puerto Rico should share in the sacrifice.

Her answer was that the panel that came on behind her would have those answers, and I would like to hear what this panel has to say. You plan that Puerto Rico should share in the sacrifice?

Mr. COLORADO. I think we did several years ago. We worked with 936 in trying, as I mentioned before to Congressman Houghton, to split the profit in such a way that an allocation, a fair allocation, would be made to the United States of those intangibles. And that was done through different alternative procedures or equations whereby the intangibles are taken into account so that a credit, a profit, is attributed to the Federal Government.

I do believe that if we look at those allocations, without having to change 936, except in relation to the allocation of intangibles to the United States or to Puerto Rico, we can figure a way in which Puerto Rico can pay its fair amount, and at the same time we would be reflecting the reality of the value of the intangibles.

There are two basic methods. One is a profit split, and the other one is cost sharing. The cost sharing, I think, has been interpreted by Treasury to be much more costly to the companies than the profit split—something that we do not agree with and we do not think was the purpose when that legislation was approved in Congress.

But I think there are ways within the concept, not of a wage credit, but of an income credit. There are still ways in which we can allocate different amounts and make it possible for the U.S. Federal Government to receive a fairer share of those intangibles.

Mr. BREWSTER. Do I take it, then, that while you don't have something ready to really propose as for Puerto Rico's share today, you are willing to work on it? And could I assume, then, that you're interested in negotiating some kind of an alternative from——

Mr. COLORADO. Well, I can't negotiate because I only represent myself, but, you know I can be of help to the committee if the committee requires me to do so.

Mr. BREWSTER. Well, as someone who is supportive of your cause, I am curious if we are talking about an all-or-nothing deal as far as Puerto Rico is concerned?

Mr. COLORADO. Excuse me?

Mr. BREWSTER. As someone who is supportive of your cause, I am curious if you are talking about either total exemption or nothing as far as this 936 provision is concerned.

Mr. COLORADO. Well, I believe that section 936 should remain as it is. But if we are forced to give something and what we give is fair, it should be through a process that would not really affect or change the 936 concept, the idea of an income-based credit, which is what is important to Puerto Rico.

Mr. BREWSTER. But you don't really have a proposal today as——

Mr. COLORADO. I don't have one, no.

Mr. BREWSTER. Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Santorum.

Mr. SANTORUM. Thank you, Mr. Chairman. I just want to pick up on a comment that Mr. Colorado said.

You said that you feel this measure will actually, you said, lose money. It is estimated under the "Vision for Change in America" that this will raise $7 billion for the Treasury over the next 5 years.

Mr. COLORADO. My position is clear. It is that this is Puerto Rican-source income. You wouldn't do that to the Dominican Republic, which has fiscal autonomy just like Puerto Rico has. See, in a State, a State would be subject to Federal taxation, and that would be the primary jurisdiction.

If 936 is eliminated completely, Puerto Rico would tax the income from those companies, and the United States would have to give a credit, and no taxes would be paid to the mainland. That is the reality. So that is why I am saying the United States is going now into the Puerto Rican-source income and for the first time in our history, taxing Puerto Rican-source income.

Mr. SANTORUM. Do you have any figures to show what your sense is of what the net effect would be on the Treasury?

Mr. COLORADO. I think that at the end, if companies reduce their income, if companies start paying taxes to Puerto Rico because they may change their incorporation, it would be very——

Mr. SANTORUM. I hear what you are saying. Have you done any modeling to determine as to what——

Mr. COLORADO. No, I haven't.

Mr. SANTORUM. Has anyone else? Mr. Nordberg, have you done anything on——

Mr. NORDBERG. We haven't done anything in connection with this particular proposal. What we have done is a couple years old, Mr. Santorum, and we hope in the next couple of weeks to have something that will be responsive to your question. But we don't have it right now.

Mr. SANTORUM. I would very much appreciate that, and if that information, Mr. Chairman, could be put in the record when available, it would be helpful.

Mr. NORDBERG. Yes, I understand. What you want is a net number.

Mr. SANTORUM. Well, yes. They are suggesting this is going to raise $7 billion.

Mr. NORDBERG. Right, but——

Mr. SANTORUM. Or save $7 billion.

Mr. NORDBERG. That is only half of the story.

Mr. SANTORUM. Well, that is what I am hearing. If CBO isn't calculating that, I want to know what your sense is. CBO predicted the luxury tax would raise money, and it didn't. What you are suggesting, at least what Mr. Colorado is suggesting, is that this is going to be a revenue loser in the long run. I would just like to see the numbers.

Mr. NORDBERG. We will provide those for you.

[The information follows:]

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April 13, 1993

Honorable Richard J. Santorum
U.S. House of Representatives
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Washington, D.C., 20515

Dear Mr. Santorum:

During the April 1 hearings before the Ways and Means Committee on President Clinton's proposal to sharply curtail the benefits of Section 936, the Possessions Tax Credit, you raised the question as to the impact of enactment of the Clinton proposal on federal transfer payments. I indicated a willingness to attempt to respond in writing.

As you know, the Clinton proposal would limit a corporation's Section 936 benefits to 65% of the wages paid to its employees. We believe that the impact on Puerto Rico's economy and levels of employment from enactment of this proposal would be severe and permanent. Some estimates place the reduction in 936 corporation employment at up to 28% of current levels, or approximately 25,000 to 30,000 direct jobs. An additional 50,000 to 60,000 indirect jobs could also be lost.

Puerto Rico's current unemployment rate is approximately 18%. As unemployment increases, outlays for unemployment compensation and migration to the mainland in search of job opportunities or higher levels of welfare benefits will likely occur. As you are aware, current levels of federal social welfare entitlements for the residents of Puerto Rico are capped at levels substantially below those which exist in the U.S. for residents of the various states.

While we are not aware of any analysis of the impact on federal transfer payments of enactment of the Clinton proposal, perhaps the following information will be helpful in trying to determine the potential impact.

In 1991, the accounting firm of Price Waterhouse did a survey of 936 corporations to determine the impact on Puerto Rican employment and federal transfer costs of a hypothetical

Page Two - Mr. Santorum

repeal of Section 936. Utilizing a macroeconomic model of the Puerto Rico economy developed by the Congressional Budget Office (CBO), Price Waterhouse estimated that by the fifth year following a "repeal" of Section 936 employment would be reduced by 70,000 jobs in 936 corporations and by 164,000 jobs throughout Puerto Rico's economy. The result would be a doubling of Puerto Rico's then 15% unemployment rate to 30%. Estimating the increased unemployment payments on the island and welfare benefits resulting from increased migration to the mainland, Price Waterhouse concluded that additional federal outlays would amount to approximately $360 million a year.

This, of course, is a very conservative estimate. Should Section 936 be repealed or substantially modified, the resulting unemployment on the island would put added pressures on the Federal Government to eliminate the caps or limitations currently restricting the availability of federal entitlement funding for Puerto Rico under the Food Stamp, Medicaid and Aid to Families With Dependent Children programs.

Currently, federal outlays for these entitlement programs run at about $2 billion per year. If Puerto Rico were to be treated as a State and the caps on these programs were eliminated, the CBO has estimated that federal outlays for the island would increase from $1.7 billion to $3.0 billion per year.

I hope that this information is helpful.

Sincerely

Carl A. Nordberg Jr.

Carl A. Nordberg Jr.

Mr. SANTORUM. Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

I would like to just discuss 936 a little bit, and the witnesses might care to comment. But it is basically that we recognize the unemployment in Puerto Rico, which has run 16 to 17 percent for the last decade, and outmigration has run about 9 percent, and the current unemployment rate is still around 16 percent. And we spend $3 billion a year on 936, and obviously it is not solving the problem.

The current structure doesn't adequately create employment in Puerto Rico. It is, however, 936, a magnet for the pharmaceutical industry, which is not labor-intensive. We used to refer to 11 people and a blender in Puerto Rico as a pharmaceutical company.

We will give them credit for more than 11 jobs in that industry, but not enough to warrant the bloated tax rate they have received over the years. According to GAO, the pharmaceutical industry receives about half of the total tax benefits, while creating only about 15 percent of the jobs that the 936 companies have in Puerto Rico.

In 1987, the pharmaceutical industry received $1.3 billion of the $2.3 billion in 936 credits, but it employed only 18,000 of the 100,000 workers. This amounted to a credit or subsidy of $70,788 per worker. The next highest benefit was in electronic and electrical workers, where it was $16,450 per employee. And all the other industries averaged around $10,593.

I would submit, Mr. Chairman, that this committee could run a pharmaceutical business if we got a $70,000 subsidy per employee, and probably do a pretty good job. Obviously, you can't structure a wage credit that would pass the red-face test to suit the pharmaceutical industry. For more labor-intensive industries, the wage credit is a reasonable incentive to operate in Puerto Rico, especially where there are geographical advantages to operating there.

But if we really intend to help Puerto Rico deal with its unemployment problem with 936, instead of continuing a tax shelter for one of the most profitable U.S. industries, the wage credit is preferable.

I am sympathetic to Puerto Rico's needs, and I have offered often, when they have come to ask us for more funds for Medicaid and Medicare, to fund those needs out of the 936 funds that are languishing in banks looking for a legal way to be invested. But I have been told "Oh, no, we can't do that."

So much for helping the poor in Puerto Rico. Still, the offer is there. We will help them in their Medicaid and Medicare benefits and we will take it out of 936. And I am waiting for the first—and the only other objection I have is running ads in magazines like Chief Executive, offering 100-percent Federal tax credit and a 90-percent Puerto Rican tax exemption to move companies out of my district or out of Indiana. That isn't the American way. We don't go stealing in somebody else's neighborhood with Federal tax dollars.

So I would suggest, Mr. Chairman, that we have to look at this issue carefully. I know all the members of the committee want to help create jobs. I am not sure that they are willing to spend $70,000 a job to do it.

Thank you, and I yield back the balance of my time.

[A statement submitted by Mr. Stark follows:]

Introductory Remarks by Congressman Pete Stark

April 1, 1993

The stated purpose of current law provision is "to assist the US possessions in obtaining employment-producing investments by US corporations."

Unemployment in Puerto Rico ranged from 15.9% to 17% from 1980 to 1988, and the estimated net outmigration was 280,000 from 1980 to 1988, almost 9% of the 1980 population. The current unemployment rate in Puerto Rico is around 16% as we spend approximately $3 billion/year on Section 936.

The current structure is not adequately creating employment in Puerto Rico.

It is, however, a magnet for the pharmaceutical industry which is not labor intensive. There used to be a reference to the drug industry having eleven guys and a blender in Puerto Rico--we'll give them credit for more than eleven jobs but not enough jobs to warrant the tax break they have received over the years. According to GAO, this one industry received about half the total tax benefits while creating only 15% to 18% of all the jobs of the 936 companies in Puerto Rico.

In 1987, pharmaceuticals received $1.3 billion of the $2.3 billion in 936 credits while employing only 18,000 of the 100,916 workers of 936 companies. This translates to a benefit in 1987 of $70,788 per worker in the pharmaceutical industry. In the same year, the next highest benefit was to the electrical and electronic equipment industry which received $16,450 per employee. For all other industries, the benefit per worker in 1987 was $10,593.

Obviously, you can't structure a wage credit that passes the "red face test" to suit the pharmaceuticals. But for more labor intensive industries, President Clinton's wage credit is a reasonable incentive to operate in Puerto Rico, especially when there are geographical advantages to operating there.

And if we are really trying to help Puerto Rico deal with its unemployment problem with Section 936 instead of continuing a tax shelter for one of the most profitable US industries, a wage credit is the way to go.

Puerto Rico has many needs, particularly healthcare needs. If we get rid of the current credit which spawns ads such as this one luring mainland jobs to Puerto Rico, I will be delighted to address the healthcare concerns.

Mr. RANGEL. Mr. Nordberg, were you seeking recognition?

Mr. NORDBERG. I would like to try to respond to Mr. Stark.

First of all, let me say that looking at a Joint Tax Committee pamphlet last year which discussed the enterprise zone legislation, the importance was pointed out of having a mix of industries, not just those that are labor-intensive, but also those that are capital-intensive. If you want the proper type of an economy, you have got to have a mix of operations.

Now, I am well aware of the GAO report. That was a report on about 20 companies, 20 pharmaceutical companies. I suggest to the committee that there are a great many other types of industries down there. But I also would point out the significant impact that the pharmaceutical industry has made in Puerto Rico. I don't think it's fair to just judge the benefit that they receive and weigh it against the wages that they pay.

The pharmaceutical industry, of course, is the most capital-intensive industry that they have in Puerto Rico. It invests the most money down there.

Second, the pharmaceutical industry is the one that pays the most taxes to Puerto Rico. It also provides the best paying jobs. So, if you balance all of the investment-type things that the companies do, what the President considers to be investments, against the benefits that they get, you will find that for every 69 dollars' worth of tax benefits that they get, they make investments in Puerto Rico of $100. So I don't think that is too bad a deal based on an overall percentage of all of the companies.

Mr. STARK. Then the gentleman would agree that creating a job with a $70,000 subsidy is a good investment of the taxpayers' money?

Mr. NORDBERG. Provided the companies do a great deal of other things. I don't think you look just at how much is paid for a wage for an individual. I think you look at a lot of other things, and you look how that company fits into the entire economic scheme of the country.

Mr. RANGEL. Mr. Crane is recognized.

Mr. CRANE. Thank you, Mr. Chairman.

In the context of job creation, the President, as you know, has a stimulus package on the table before us, and it is a little over $16 billion. It is going to create some temporary jobs, a couple hundred thousand, as I understand it, and the cost is only $90,000 for one of those temporary positions under his stimulus package. So, conceivably, we could shift, reorient his stimulus package exclusively to Puerto Rico, and that is more jobs, really, by far than 936 has created so far down there, coupled with a much more generous form of subsidy for that job creation.

What do you think of that, Carl?

Mr. NORDBERG. I think that would be a great idea for the companies in Puerto Rico. However, I may represent some other companies that have got their eye on that money from the investment tax credit provisions.

Mr. CRANE. Well, I want to remind everyone that Baxter, Inc., has its headquarters in my area. Baxter also has many facilities in Puerto Rico. However, Baxter is growing in my area, growing prodigiously. It is not packing up and leaving the State of Illinois.

Baxter told me that section 936 has raised the level of wages in Puerto Rico. They also said the 936 program has contributed mightily to the overall economy in Puerto Rico. For example, hourly wage rates are up there $7 to $8 an hour. In the Dominican Republic, they are only $1.46 an hour. Costa Rica, I think, is comparable to the Dominican Republic. We all remember the boat people leaving the Dominican Republic trying to flee to Puerto Rico because of the economic conditions in Puerto Rico being vastly superior.

I find it hard to understand why a person would want to tamper with something that remarkably has worked so well. Could you give me historically, Tito, the average wages before the 936 and the average unemployment rate in Puerto Rico?

Mr. COLORADO. The unemployment, or the underemployment was much higher than what we have today, obviously. But the wages, we are talking about $15 a week or $15 a month in some cases, an average income per capita of $150 to $250.

You know, it is amazing when you hear someone say that $75,000 per job is a tremendous cost when our cost really, average, is $20,000. And then the President's program cost is $50,000. So what is so good about 50 and so bad about 75?

It is very hard to be able to understand that, and then at the same time talk about the issue of the companies that we may be losing, as in your case you know it is not so. We have companies that are creating more jobs in the mainland because of Puerto Rico. On the one hand, we say we are losing pharmaceutical jobs in the mainland, and on the other hand, Mr. Stark says there are not enough jobs in Puerto Rico, it doesn't create enough pharmaceutical jobs.

Well, if it doesn't create enough jobs, then it is not important.

Mr. CRANE. Well, I just want you to know that there are many of us who have been impressed with the success of the 936 program, and the consequences are so readily visible when you visit Puerto Rico. You have got my total support, retention of the current program. I think the administration figures about the revenue receipts are not accurate.

Yes, Carl?

Mr. NORDBERG. We often overlook what Mr. Rangel is always asking us about; that is, how does 936 help the quality of life in Puerto Rico? I just want to mention one thing.

In 1970, 12 percent of the 936 work force in Puerto Rico was college-educated. Today that number is 40 percent.

Now, I think that is pretty impressive, and you have got to remember that is during the same period that Puerto Rico was replacing these labor-intensive industries with the high-technology companies. So, Puerto Rico has made a serious change here, and the well-being of its people has improved significantly in the last 20 years because of that switch.

The high-paying jobs are coming in, the high-technology jobs are coming in, and the low-paying jobs that would benefit from a wage credit are leaving Puerto Rico. They have left.

Mr. CRANE. Well, I thank you all for coming before the committee and testifying. Congratulations on your testimony, too, Mr. Ambassador.

Ambassador BERNAL. Thank you.

Mr. RANGEL. Mr. Payne.

Mr. PAYNE. I would like to thank the gentlemen for testifying, and I have no questions. Thank you.

Mr. RANGEL. Mr. Reynolds.

Mr. REYNOLDS. I, too, have no questions.

Mr. RANGEL. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

I appreciate the testimony. I don't support the President's proposal, but I also believe we ought to make some changes. I don't know that it is completely fair to take a company who has gone into an area and made investments, and then say we are going to change it. I think there ought to be some period of time before those changes take effect so that there is notification, there is fairness; and if we are going to make any change, it ought to be done gradually.

Having said that, I would not allow any new companies to come in. I would leave it the way it is. And I would take any tax credits for new companies and use them in enterprise zones in this country.

Now, I will support whatever is reasonable, but I also want to ask a question. And I know you don't like that, but that is where I am coming from. What about the whole runaway-plant question that Mr. Stark brought up. There are a lot of people in my district feeling that you have a responsibility legally not to accept runaway plants. In fact, however, you are encouraging it with your advertisements. And, in fact, you have brought runaway plants into Puerto Rico.

Mr. COLORADO. I think if you read that advertisement, it doesn't say what Mr. Stark showed it as saying. It really means that, you know, Puerto Rico is an alternative. It is not move to Puerto Rico; it is expand to Puerto Rico.

In our legislation, we have clearly prohibited for a company to do just that.

Mr. SUNDQUIST. Well, I wouldn't be so bold as to say that you are going to say in a magazine move to Puerto Rico and avoid all the taxes, but I think that is clearly the message. What is your responsibility and what actions do you take——

Mr. COLORADO. If anyone——

Mr. SUNDQUIST. Well, let me finish. What is your responsibility and what actions do you take to prevent runaway plants from coming to Puerto Rico at taxpayers' expense?

Mr. COLORADO. First of all, under taxpayer expense is doubtful. We would have to discuss that because these are Puerto Rican-source income that should be taxed in Puerto Rico. This is one of the fallacies about the whole thing, thinking that these companies would pay the taxes in the mainland when they should pay them in Puerto Rico. That is No. 1.

Mr. SUNDQUIST. Let's leave that question aside.

Mr. COLORADO. OK, but that is an issue that——

Mr. SUNDQUIST. We are, in fact, subsidizing huge amounts of money. I don't think that necessarily is——

Mr. COLORADO. You are not. You are not subsidizing a huge amount of money, because those funds would not be there anyway. That is a reality.

Now, on the other hand——

Mr. SUNDQUIST. Put me down as having a major disagreement with you.

Mr. COLORADO. We can discuss that at any time you want to, sir.

Now, in relation to the issue of the runaway companies, I can show you that we generate many, many—for every job that may be lost, we generate hundreds of jobs here in the mainland. In addition to that——

Mr. SUNDQUIST. You are not answering my question.

Mr. COLORADO. OK, I am going to answer your question now. The issue of runaway is considered in our application for tax exemption, where under sworn statement you have to state that you are not going to affect a plant in the United States. Somebody is swearing that he will not do that, and if he is telling a lie or if he is not telling the truth, he can be subject to lose his tax exemption. He can lose the whole tax exemption and have to pay those taxes to Puerto Rico.

But nobody has challenged this up to now. The only company that did it went directly to the court. It is the only company that has done it. But we do have a procedure in Puerto Rico to do that.

Mr. SUNDQUIST. I understand. But there are many in my district who think that procedure is not working. Now if some of my constituents went to see you or whoever—who should they see to look up a specific instance? Would you give them the facts and the information, the details and the papers that show whether or not that is true or not true? Would you give them that information?

Mr. COLORADO. Personally, as a friend, as I hold no position, I can help any—and I have talked a lot to some of the union members on this, so I am willing to talk to them and I am willing to help them get through the Government whatever they need.

Mr. SUNDQUIST. Who in official position will write me a letter saying that we will allow them to look at the papers and——

Mr. COLORADO. You don't have anyone in an official position here.

Mr. SUNDQUIST. Well, you know some people. You are obviously representing Puerto Rico.

Mr. RANGEL. If the gentleman would yield, they have a nonvoting resident commissioner right in our own body, and I am certain that he would be able to get something for you.

Mr. SUNDQUIST. Mr. Chairman, I thank you. What has happened is that they have not been able to get that information from officials in Puerto Rico, and I think they are entitled to that information. I don't think you want Puerto Rico to have the reputation of accepting runaway plants.

Mr. CRANE. Would you yield for just a second?

Mr. SUNDQUIST. I would be glad to yield.

Mr. CRANE. When Tito was the representative here, did you ask Tito for that information then?

Mr. SUNDQUIST. No. My constituents have dealt with the Puerto Rican Government.

Mr. COLORADO. I can assure you that none of them came to me last year, and I was here. And the ones that came discussed the issues with me and got their information back.

Mr. SUNDQUIST. Yes. See, the requirement is in Puerto Rican law, not in United States law. I understand that.

Mr. COLORADO. Yes.

Mr. SUNDQUIST. OK. I will accept your word that we can get that information.

Mr. NORDBERG. Mr. Sundquist, could I just mention one thing?

Mr. SUNDQUIST. Yes.

Mr. NORDBERG. There have been recent developments in this area that I think should be mentioned. Two companies have recently been challenged on their requests for tax exemption in Puerto Rico, and there are hearings scheduled by the Fomento organization in Puerto Rico, which is the one that controls. Actually, those hearings were scheduled to be this week, and there will be people testifying behind us, I think, that can give you more information on that. But my understanding is that those hearings have been delayed, postponed at the request of the unions that are involved. Originally, they requested a 120-day extension, and it has been moved or postponed maybe 3 months.

Mr. SUNDQUIST. I am not here to say that it is a runaway or not a runaway. I am here to say that the only way to know that is if the information is available.

Mr. COLORADO. As a matter of fact, we sent a draft of regulations to Congressman Pete Stark. We never got an answer from him.

Mr. SUNDQUIST. Just to summarize—and I know I am past my time, Mr. Chairman—I believe that when the Government makes an agreement on a basis, we ought to keep that basis. The plants that are there, I think there has to be some consideration given to people who are already there. I would support trying to preserve what is there or some long-term phaseout of it. Then we will see what happens on the rest of them.

Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Reynolds.

Mr. REYNOLDS. I know I said earlier I didn't have any questions. You know, as a freshman, maybe there are some things going on that I don't quite understand, but could I just make a recommendation, if I could be so bold to do that?

I don't think any of us are here trying to be an adversary or being in that sort of position. I think all of us are sincerely concerned about the situation in Puerto Rico and trying to find out which side of this is the best side for the constituents in our district and also for the people on Puerto Rico. And that is the position that I have taken.

I am sincerely concerned about the jobs and how this is going to affect jobs in Puerto Rico, either in a positive way or in a negative way. So if someone wants information, that will help us. And it will help me, and it will help this committee.

Thanks very much.

Mr. RANGEL. Mr. Levin.

Mr. LEVIN. Mr. Chairman, I just had one question. Mr. Reynolds really has kind of hit the same note. I ask this question sympa-

thetically. The President has really opened this question of 936. That is clear.

Is your feeling or feelings that there are no basic problems with it, that there aren't any significant weaknesses as well as strengths, that there is no way to reshape this that would be both in the interest of Puerto Rico and the rest of the United States.

Mr. NORDBERG. Mr. Levin, that is one of the problems we run when we try to defend 936. People interpret our defense as no change at all. I think that the 936 community this time realizes that some changes are going to be in order.

I think what the Puerto Ricans are saying today here is: Don't hit us with a disproportionate share. They are being asked to accept a $7 billion hit, and that is too much.

They also are saying that they want to keep all of the different types of industries in Puerto Rico because they are all important. And it seems to me that we can modify 936 to meet all of those goals that the Puerto Ricans have and maybe that the President has.

I am not suggesting, though, by any means that we can do that and produce $7 billion. That can't be done.

Mr. LEBRON. I would also make a comment, and it is that we recognize that there may be changes to 936, but we are looking for fairness. The proposal from President Clinton that we are talking about represents a 28-percent reduction in employment, in jobs in Puerto Rico. That is around 90,000 jobs. We are saying that the companies will be confronting a reduction in the tax credit of around 72 percent. That means that the 936 funds that are available in Puerto Rico will be reduced proportionately. We are saying that the taxes that are being collected by the Puerto Rican Government will be reduced by around 72 percent or so. That is equivalent to around $420 million, and that is equivalent to around 10 percent of the total tax collected by the Puerto Rican Government.

Just imagine what would happen in the United States if the tax collected by the U.S. Government were reduced by 10 percent. That is something that will occur immediately, within a 1-year time period, because the companies will restructure in such a way that they will report in Puerto Rico only the profits that are equivalent to the tax credit they will obtain in the United States. So we are talking of an immediate impact on 936 funds, immediate impact on the tax collected by the Puerto Rican Government, and a long-term impact on the jobs that are in Puerto Rico.

We are talking 90,000 people, 90,000 jobs, on an island where we already are confronting an 18-percent unemployment. That is not fair. We are talking about fairness, and that is why we say that the Clinton proposal is not fair to Puerto Rico.

Ambassador BERNAL. May I comment?

Mr. RANGEL. Ambassador Bernal.

Ambassador BERNAL. Thank you, Mr. Chairman.

I wanted, just before we close, to interject something on behalf of the 10 CBI countries, which most of the discussion has focused on Puerto Rico. I just wanted to reiterate how essential this program is to the 10 sovereign Caribbean countries which participate, and to also remind you that there are other countries in the pipeline and there are nearly $200 million of investment pending.

I would like to make the point that the 936 is the indispensable investment component that complements the trade opportunities created by the CBI, and to remind you also how important the CBI is to the region from an economic point of view, political and security. It is a large and growing market for U.S. industry. And I would make the point that the jobs created in the Caribbean are complementary to the United States.

Finally, sir, I would make the point that the stability and predictability of the economic environment is a critical determinant of growth in the CBI region. Given the importance of trade and investment and development assistance between the United States and the CBI, part of the predictability of that economic environment is U.S. policy toward a region. We have been undertaking a process of economic reform and adjustment based on the assumption of the continuity of the CBI and the 936 funds, and it would have serious dislocation effects if anything was to happen to the 936.

So on behalf of the 10 beneficiary countries and those who are prospective members, I want just to emphasize that in the considerations and deliberations, please remember these CBI countries.

Mr. RANGEL. Ambassador, you know, I was just thinking that you shouldn't be too optimistic. If you have seen how we treat citizens in the Caribbean I don't know how the other 10 countries will address their views. However, you do have an opportunity that they don't have in Puerto Rico, even though we don't officially have an Assistant Secretary of State for the Caribbean and South America. But I would strongly suggest that you have your views made known to Deputy Secretary of State Clifton Wharton. He has a sensitivity and concern for that area. Of course, those of us in the Congress are very anxious to do what we can to open up the communication. And if we are lucky with you, maybe we can do the same for Puerto Rico.

Ambassador BERNAL. Thank you. Mr. Chairman, may I just add that you will be happy to know that the Caribbean Ambassadors have an appointment with Deputy Secretary Wharton next week.

Mr. RANGEL. Terrific.

Mr. PICKLE. May I reply to Mr. Bernal?

Mr. RANGEL. We are going to try to get one for the Governor of Puerto Rico as well.

Mr. PICKLE. I made the statement earlier that we should be happy about the operation of the CBI program in connection with 936 funds, because you are making investments. You are going over an amount of money we have set as a minimum. So I don't think any of us on the committee ought to minimize that accomplishment, and I would want to make it plain that we are proud of that. And our committee wants to come down there and visit some of the CBI countries, hopefully this year, just to see the progress they have made.

But I simply want to make the observation to you that, as good as that program has worked, it could even do better. But most important is when you consider the amount of money involved in relation to the $10 to $12 billion on deposit, that $100 million represents only 1 or 2 percent of the money that is involved.

So to say you have got to save 936 funds because you have got 1 percent of that money invested in CBI programs is not really a complete defense. But we ought not minimize the helpfulness of the program. So I recognize that and want to make that plain.

Ambassador BERNAL. Thank you.

Mr. RANGEL. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman. I have no questions, but I do want to just comment that it is worth remembering that we adopted the CBI at a time when we were convinced that unless the Caribbean Basin nations developed economically, there would be civil war and strife on our border that would affect us. We developed it as a policy that we had hoped would have avoided the difficulties of contra aid and those kinds of things.

It was an enlightened moment, and I am pleased to see that after all these years it is beginning to make a real difference. I would hope that we wouldn't undermine a policy that has begun to enable our neighbors to enjoy the economic prosperity that alone can assure peaceful and good relationships amongst us all.

Thank you.

Mr. CARRION. Mr. Chairman?

Mr. RANGEL. Mr. Carrion.

Mr. CARRION. Thank you very much, Mr. Chairman.

936 funds have been mentioned here a couple of times, and I think that some comments are due now regarding the use of those funds.

First of all, we feel that what we call passive income, which is really investment income, has produced substantial benefits for the Puerto Rican economy at a minimal cost to the U.S. Treasury. There are really two avenues of investment for these funds: First, those intermediated by depository institutions and what we refer to as similar institutions, which are brokers; and, second, direct investments by 936 corporations.

Funds on deposit with these banks, brokers and savings banks amount to just about $10 billion. However, due to a local regulation—regulation 3582—which governs the way in which these 936 funds are invested, the total invested 936 funds generate close to $13.5 billion of productive assets. Let me break this down for a minute.

The 936 funds on deposit with financial institutions amount to about $10 billion, and those funds generate approximately $13 billion in productive assets as a result of regulation 3582. Those $13 billion are broken down as follows: $2.5 billion in investment and/or loans to the Government of Puerto Rico; $5.6 billion in commercial loans and discounts—and I think it is good to point out here that due to the nature of Puerto Rico's geography, we have a lot of small towns. The nature of Puerto Rico's banking industry, which has branches in these small towns all over the island, allows these funds to be loaned throughout the island. About 65 percent of the number of commercial loans are for amounts less than $25,000; 90 percent of the number of those loans are for amounts less than $100,000, which means that these lower cost funds are being lent all over the island to small businesses. Loans to borrowers in CBI countries amount to $221 million, mortgage loans, $3

billion, student loans, $128 million, and other eligible activities authorized specifically by the regulations, about $2 billion.

Let's look at direct investment by 936 corporations, which amount to about $5 billion—and here, again, we have to stress that these direct investments by 936 corporations tend to be of a longer nature, which means that the economy of Puerto Rico is benefiting in a much more direct way by these types of investments. These funds have been invested in housing finance, $1.7 billion, the Puerto Rican public sector, $1.6 billion, to AFICA, $1 billion, CARIFA, $609 million, and other CBI investments, $300 million.

As you can see, Mr. Chairman, the funds that are on deposit with the banks are not lying idle so that the banks can make money on them, they are being intermediated very effectively throughout Puerto Rico and, as of late, throughout the Caribbean. And I think this is a very important issue because the cost of this program to the U.S. Treasury is very small.

Mr. RANGEL. Mr. Pickle.

Mr. PICKLE. Well, Mr. Chairman, let me ask Mr. Lebron this, and perhaps Mr. Carrion would want to make a comment about it. What use has the Puerto Rican Government made of 936 funds on deposit in Puerto Rican banks? What use has it made of that money?

Mr. LEBRON. I did not follow that.

Mr. CARRION. Could you repeat the question, sir, please?

Mr. PICKLE. I believe, Mr. Lebron, that you were talking about the uses—and you, Mr. Carrion, made a comment. I want to know what use have the Puerto Rican banks really made of this amount of money on deposit? How did they use it?

Mr. LEBRON. That is what he was explaining.

Mr. PICKLE. I want to know more details. How are they using that money? How are the Puerto Rican banks, the Government banks, using the money that is on deposit? Low-interest loans; is that correct?

Mr. CARRION. That is right. Yes, sir.

Mr. PICKLE. On both Government operations or loans just across the board?

Mr. LEBRON. It is being used for commercial loans. It is being used to finance infrastructure projects, roads, hospitals, you know, commercial——

Mr. PICKLE. Well, I would think, just making a review of this, that you are interested in 936 money primarily for the money that goes into the Puerto Rican banks that you can use for low-interest loans, and that is how you run your Government. I don't think you are here to protect Chase Manhattan or Citibank—although I am sure you have got a friendly relation with them, obviously—and I can't believe you are here to protect all the pharmaceutical companies because they are making investments down there and they realize a lot of income and pay no taxes on it, or very, very little taxes on it. You may be friendly towards them. What you really want, I assume, is money that is in the Puerto Rican banks that you can use to run your Government with. And if you are honest about it, I think probably that is what you are trying to protect, more than the individual banks or the others.

I don't know that I can say that that is altogether bad, but I think the American people are reaching a point where they look down at Puerto Rico and we say we have $10 or $12 billion on deposit that we in the United States are not receiving any return on, except for the assistance these funds provide to the Government of Puerto Rico. And we should not be inconsiderate of that, but I don't say that we can say that this program has been a 100-percent success from our Government standpoint. We have got to look at it differently and more fairly.

Now, you people here are all testifying that we just can't touch the 936 funds. We are going to try to find out, this committee, specifically how many, really, new jobs are being created, if there are very many now, or is that kind of a static figure? Of course, you are going to tell me you are going to lose a lot of jobs.

I will ask you a question. What if you go to wage credit? Will that really create more jobs? At least it is a different, and maybe even a better stimulus, I think. That is what the President recommended. None of us want to do damage to Puerto Rico, but we are looking down there and seeing these funds, and every State in the Union would like to have a slush fund like this, or of some kind.

So I think we have just got to face reality, and I think you are trying to protect the money you have down there to help run your Government. Maybe that is not altogether bad. But you have to weigh that in connection with what other States would like to have.

I thank you, Mr. Chairman.

Mayor ACEVEDO. May I make a comment, sir? From our people's point of view, what I can ask another human being, before you take a certain program out, is to be as responsible as possible of being sure that what you are proposing to substitute, what will be the effect on our people.

Our information reflects that we have now the assurance of a number of employment that is extremely significant to Puerto Rico. And if there is a weakness in the program, it is that we still have a very high unemployment in Puerto Rico. But what is being proposed, according to our information, will just do the opposite, will take what we have without substituting what we need. And in that respect, I will invite the consideration of looking at what are the effects of what we are proposing now. If we have lost low labor-intensive jobs in the last 10 years, on the same amount, more or less, of the ones that we have been able to create, then to take that as a strategy would put Puerto Ricans without incentive for new jobs in Puerto Rico.

So what I will invite is to—I asked the Treasury Department and I asked the White House, have you studied the consequences of what you are proposing in relation to the economy of Puerto Rico and for the future of investment in Puerto Rico? They answered they haven't. That I think is a crucial fact when you deal with realities, not with theory. We have permanent jobs, and we don't want to lose them unless we have a better alternative.

Mr. PICKLE. Mr. Colorado, or any of you, how would replacing section 936 with a wage credit affect the Puerto Rican Govern-

ment's ability to make loans for Government operations? How would that affect you if you went to the wage credit?

Mr. COLORADO. It wouldn't just affect the Government. A large amount of the funds are utilized today for the mortgage of the middle class and the poor people of Puerto Rico. Their mortgages are today cheaper 1.5 percent than what they used to be before. And, mind you, I don't know why, but before we were able to use 936 funds, interest in Puerto Rico for mortgage loans were much higher than in the mainland. So it is helping each individual in Puerto Rico who owns a home to be able to pay $50, $60, $70 less a month. That is important. That is very important for Puerto Rico.

These projects will destroy that.

Mr. PICKLE. Well, I have the feeling that if you went to the wage credit, that that would not affect your basic operations of Government programs in Puerto Rico.

Mr. COLORADO. It would kill it completely because there is no incentive to keep the funds in Puerto Rico if you are going to tax them. The wage credit will tax those funds at U.S. rates because these are the marginal funds.

Mr. PICKLE. But you still get a 65-percent wage credit.

Mr. COLORADO. It is 65——

Mr. PICKLE. Or 100 percent.

Mr. COLORADO. No, no, no. Even 100 percent is 100 percent on that amount. The extra amount will be taxed freely.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. RANGEL. Well, Ambassador, you have been successful in getting an appointment with Deputy Secretary of State Wharton. Would my fellow citizens from Puerto Rico share with me, have you had any success to meet with the President or Secretary of Treasury or anyone in the administration, those people that have made the decision? Do you know how high you have been able to go?

Mayor ACEVEDO. We met this week, Congressman, with Ms. Regina Montoya and with the Treasury Department.

Mr. RANGEL. What are their titles?

Mayor ACEVEDO. He is the Deputy Assistant Secretary for Policy at the Treasury Department and she is the assistant to the President.

Mr. RANGEL. Well, I would want you to know that if your representatives want to meet with the President, many of us would be able to support this. But I hope you have not gotten the flavor that the American people are kind of fed up with our citizens in Puerto Rico. I don't know, do you receive any preferential treatment under the draft laws when America is being attacked?

Mayor ACEVEDO. No, sir, and I am a member in the U.S. Army Reserve for the last 16 years. Tonight, I am supposed to have a class at the command general staff. My father was a veteran, so I didn't get any difference in treatment in that, and I am proud of fulfilling my job.

Mr. RANGEL. It is unbelievable how people talk about Americans losing jobs to Americans, but I think that is a hurdle that is going to be very, very difficult to overcome, so whatever you can do to try to change that before it comes here I think would be very helpful.

I want to publicly thank Tito Colorado for the fantastic job that you have been able to do in running Fomento and the relationships

that you built with those people that come here even today from the Caribbean area to congratulate the United States and, therefore, your efforts in making the program work.

I want to thank the distinguished mayor from San Juan for coming here to make certain that we have a bipartisan approach to this problem that affects so many Puerto Ricans and, of course, the representatives from the manufacturing area and the banking area, so that at least we will have the benefit, if the White House does not, as to what you think could happen, for those who say that if it has to be a substitute, at least have hearings, at least know what the impact is going to be; of course, representing the 936 companies, you know what you have to overcome here, and it would just seem to me that whatever political influence you are able to exercise, that if ever our citizens in Puerto Rico need it, they need it now.

I want to thank this panel for helping us in whatever we can do to help.

Mr. RANGEL. The next panel is Miriam Ramirez de Ferrer, doctor, president, and founder of Puerto Ricans in Civic Action; Dr. Eric Munoz, National Puerto Rican Coalition, the chair of the Public Policy Committee; Richard Leonard, director of special projects for the Oil, Chemical & Atomic Workers International; Mitchell Tucker, United Rubber, Cork, Linoleum & Plastic Workers of America, International Union, AFL–CIO; and Peter Johnson, Caribbean/Latin American Action.

I don't know whether the panel was here when the chairman indicated that we are trying to maximize the questions that the members would have, and so if your statements are beyond 5 minutes, they will be entered in the record in their entirety, and it would be very helpful if you could restrict your oral testimony to the 5-minute restriction, so that the members would have the maximum time to make inquiries.

We will start with Dr. Miriam Ramirez de Ferrer, speaking for the Puerto Ricans in Civic Action.

STATEMENT OF MIRIAM J. RAMIREZ DE FERRER, M.D., PRESIDENT AND FOUNDER, PUERTO RICANS IN CIVIC ACTION, ACCOMPANIED BY LUIS P. COSTAS ELENA, COUNSEL

Dr. RAMIREZ DE FERRER. Thank you for allowing us to testify today.

As a physician, Puerto Rico's unemployment rate of 18 percent tells me that I am dealing with a sick economy. Section 936 has produced too few jobs in Puerto Rico, at a huge cost to the United States Treasury. Its workers comprise only 12 percent of the total work force on the island. It has obstructed Puerto Rico from a strategy of economic growth, where our people could earn their own way. It has stopped us from growing like the rest of the 50 States.

Although part of the $3 billion tax break provided by section 936 has been used to hire experts inside the Washington Beltway to defend it, we have persisted with our message, and you have heard us. For this reason, we thank many members of this committee. We thank Congressman Rostenkowski, Congressman Stark, Congressman Pickle, Senator Pryor and many others. We also thank Presi-

dent Clinton for including the economic changes that we have been advocating in his agenda for change.

We thank all those who support our request that the present failed economic model in Puerto Rico based on section 936 be replaced with a sound domestic economic policy which will bring benefits to all the citizens of the United States, including those living in Puerto Rico. We particularly thank your wonderful staff for the many hours spent with us. We commend you for not expecting us to settle for a tax credit program in lieu of the American dream.

There have been many studies on 936. One of the studies presented by proponents of section 936 has been done by a distinguished economist of Price Waterhouse who worked for Congress and at the time defended a wage credit formula as a substitute. However, your own studies confirmed our findings. The proponents of 936 now have to answer to those concerned with a horrendous deficit and our incredible health care costs. They can no longer defend rationally why almost 50 percent of the section 936 tax benefits go to 60 drug companies that only provide 18 percent of the jobs of all section 936 corporations.

Therefore, we support President Clinton's proposal to change section 936, but we must insist that in any proposal seriously considered as an alternative to section 936, Puerto Rico must be included in the national domestic policy plan, and not as if it were a separate entity from the United States.

The policy of the Clinton administration and the 103d Congress toward Puerto Rico must be the same as it is for the Nation as a whole. A gradual phasein of a wage credit or creating an alternative under the old system will not help, since it will create another special tax treatment for who knows how many years. Congress should phase in the wage credit system immediately, and only for 2 or 4 years, when it should again be re-evaluated. Puerto Rico needs to be considered as a possible site for an enterprise zone such as described in last year's H.R. 11.

We strongly believe that 936 should be phased out, regardless of Puerto Rico's political status, because it represents an unfair and unnecessary burden on the United States taxpayers and the United States Treasury. So don't be distracted by the spin doctors who can't find a way to defend their case and now claim that our interests in this matter is related to our push for statehood. This is just another argument to distract the discussion from the real issues.

Rational managed change in the section 936 program is what this is really all about. Please be assured that Puerto Rico's self-determination process will turn on much more fundamental issues than what you do with it.

In the last months, when we thought all facts on 936 were known, we heard that probably as many as one-third of the 18,000 workers in pharmaceutical companies work under temporary job services. This constitutes a cruel economic and mental abuse of the workers and their families. Please order an investigation into this matter and find a way to stop it. It is an easy way out of having to pay employee benefits, curtailing labor rights, and bypassing unions.

We also insist that any change in section 936 must be accompanied by improvements in our health system and assistance to the

needy. We don't want you to forget that the taxes that these companies will bring to the United States Treasury will come from business generated in Puerto Rico. 936 is not critical to Puerto Rico's economy, and any change will not cause the economy to collapse.

Over the last 20 years, the rate of unemployment has fluctuated between 13 and 17 percent. To sustain this position, we include the testimony offered to the Puerto Rico Senate by Marcos Rodriguez, president of the Puerto Rico Government Development Bank. According to that data, most of the 936 companies will not leave Puerto Rico if section 936 is significantly changed. The Clinton administration and Congress will be doing the right thing by defining a national economic strategy which includes Puerto Rico. As loyal U.S. citizens, we believe that the United States will keep her promise of democracy and equality.

Mr. Chairman, that concludes my testimony. For the record, I would like to submit the additional items included in my written testimony, including work by Mr. Luis Costas and two other editorials. He will also be available for the question and answer period.

[The statements of Dr. Ramirez de Ferrer and Mr. Costas follow. Additional items mentioned are being retained in the committee files.]

PUERTORICANS IN CIVIC ACTION
PUERTORIQUEÑOS EN ACCION CIUDADANA

Miriam J. Ramirez de Ferrer MD
President

Statement by Miriam Ramirez de Ferrer
President, Puerto Ricans in Civic Action
Ways and Means Committee
April 1, 1993

Thank you for allowing us to present testimony which will have a direct impact upon the political and economic future of the 3.5 million U.S. citizens in Puerto Rico.

These are great days for our organization. We are seeing the successful result of our hard and persistent work to explain to the United States government, the real truth behind Section 936. Since 1986 we have been coming to Congress to tell you that Section 936 is producing too few jobs in P.R. at a hugh cost to the U.S. Treasury.

Section 936 workers represent only a small portion of the Puerto Rican economy. According to Puerto Rican Government statistics, they comprise only 12% of the total work force on the island. It not only carries outrageous costs, but it is also highly ineffective. As a physician, Puerto Rico's persistent unemployment rate in excess of 15% and a growing public sector tells me that I am dealing with a sick economy.

Section 936 is largely the cause of this sickness because it has obstructed P.R. from a strategy of economic growth where our productive people could earn their own way. It has stopped us from growing like the rest of the 50 states.

Many people said that our grassroots organization would be crushed by the propaganda and lobbying power of the pro-936 machinery and their unlimited economic resources to protect their 3 billion tax break.

As a matter of fact, part of the $3 billion tax break provided by Section 936 has been used to hire experts inside the Washington beltway to defend Section 936. One of the studies to support Section 936 has been done by a distinguished economist of Price Waterhouse who worked for Congress and at the time defended a wage credit formula as a substitute for Section 936.

But we have persisted. We visited you frequently, we mailed you the facts. We faxed you the facts. We presented our studies on Section 936, and you heard us.

This exercise in democracy is the most wonderful example of what the United States is all about. Many tried to discourage us by comparing our guest with David and Goliath, but your actions prove that the common individual is important to the United States and will be heard.

For this reason we thank many members of this Committee. We thank Congressman Rostenkowski, Congressman Stark, Congressman Pickle, Senator Pryor, and many others. We also thank President Clinton, for including the economic changes that we have been advocating in this agenda for change. We particularly thank your wonderful staff for the many hours spent with us. We commend you for not expecting us to settle for a tax credit program in lieu of the American dream.

GOVERNMENT STUDIES CONFIRM FINDINGS

And when you ordered your own studies, these confirmed our findings! The proponents of 936 now have to answer to those concerned with the horrendous deficit and our incredible health care costs. They can no longer defend rationally why almost 50% of the Section 936 tax benefits go to 60 drug companies that only provide 18% of the jobs provided by all Section 936 corporations.

They can no longer defend in a plausible way the fact that the tax benefits have almost tripled since the 1970's, while the number of jobs provided has remained relatively stagnant in the same period.

WE AGAIN EXPRESS OUR GRATITUDE FOR THE SUPPORT TO OUR REQUEST THAT THE PRESENT FAILED ECONOMIC MODEL IN PUERTO RICO BASED ON SECTION 936, WITH ITS HIGH PRESSURE, TAX BENEFIT DRIVEN, AND BIG BUCKS POLITICS THAT SURROUND IT, BE REPLACED WITH A SOUND DOMESTIC ECONOMIC POLICY WHICH WILL BRING BENEFITS TO ALL THE CITIZENS OF THE UNITED STATES INCLUDING THOSE LIVING IN PUERTO RICO.

THEREFORE, WE SUPPORT PRESIDENT CLINTON'S PROPOSAL TO CHANGE SECTION 936.....but we must insist that any proposal seriously considered as alternative to Section 936, meet the following conditions:

PUERTO RICO MUST BE INCLUDED IN THE NATIONAL DOMESTIC POLICY PLAN AND NOT AS IF IT WERE A SEPARATE ENTITY FROM THE UNITED STATES.

Since Puerto Ricans are United States citizens and P.R. is part of the United States, PUERTO RICO WOULD BENEFIT IF TREATED AS AN INTEGRAL PART OF A NATIONAL GROWTH AND JOB CREATION STRATEGY, just as we have been part of the national defense strategy since all World Wars and during the Cold war.

The policy of the Clinton Administration and the 103rd. Congress towards Puerto Rico must be the same as it is for the nation as a whole.

For example:

- We do not believe that a gradual phase-in of a wage credit or giving a 936 company an alternative under the old system will help since it will only create another special tax treatment for who knows how many years.

- Congress should phase-in the wage credit system immediately and only for two or four years when it could again be re-evaluated. The target jobs tax credit, which is the only wage credit in the code, has been reviewed, improved and re-authorized every one or two years.

- Puerto Rico needs to be considered as a possible site for an enterprise zone. The enterprise zone proposal in last year's H.R.11 bill included wage credits, reduced capital gains taxes, lower depreciation rates, and new investment tax credit.

SECTION 936 MUST NOT HIDE BEHIND THE STATUS QUESTION

You probably know that our grassroots organization is mostly comprised of people who desire statehood for moral, political, and economic reasons, and our reasoning is sound. However, let me assure you that I strongly believe that 936 should be significantly refined and changed regardless of Puerto Rico's political status, because it represents an unfair and unnecessary burden on the U.S. taxpayer and the U.S. Treasury.

And please, do not be distracted by the spin doctors who can't find a way to defend their case and now claim that our interest in this matter is related to our push for statehood. This is just another argument to distract the discussion from the real issues.

Rational managed change in the Section 936 program is what this is really about. Please be assured that Puerto Rico's self determination process will turn on much more fundamental issues than on what you do on Section 936.

In our view, this Committee and the Congress must not become unduly preoccupied with Puerto Rico's political status issue in connection with its evaluation of President Clinton's proposal.

The President's position should be considered on its merits as part of an overall national economic recovery program to which Puerto Rico must be willing to contribute, and from which Puerto Rico must benefit along with the rest of the nation. You must reject the notion that the interest of Puerto Rico and those of the Nation are at odds.

However, we would be remiss not to say, that until the people of P.R. achieve real self determination and establish a more perfect relationship with the Federal government, we will have no basis for knowing if the so-called benefits of 936 were worth the price we have paid by remaining a territory, subject to Federal law and policy promulgated without our democratic participation.

We were appalled to see the pro-936 components organize and practically force the workers in P.R. and their political leaders to march in their favor. But, although we thought that all that could be done and said about Section 936 had been said, we recently discovered a new outrageous fact:

SECTION 936 TEMPORARY EMPLOYMENT

We have strong reasons to believe that more than 1/3 of the 18,000 workers in pharmaceutical companies work under temporary job services, a practice that we understand is also being widely used in the United States.

Some of these "temporary work" companies in Puerto Rico have even put up shop right next to the areas where these corporations operate. This constitutes a cruel economic and mental abuse with the workers and their families!

Considering the fact that these companies are not paying federal taxes and that they are making excessive profits in their drug prices, we ask you to order an investigation into this matter and find a way to put a stop to this.

This is an easy way out of having to pay employee benefits, curtailing labor rights and bypassing unions. These workers might even be collecting federal unemployment between jobs. This might be legal, but it is definitely immoral and you owe it to your constituents to look into this.

RESULTS OF THIS SPECIAL TAX TREATMENT

And what has been the result of pursuing economic development based on federal tax exemption? Today P.R. stands at the bottom of the economic ladder, compared to the 50 states.

The most significant impact Section 936 has on the island is that this supposed great economic credit given to us by Washington is also the reason given for denying the loyal U.S. citizens in P.R. greater or even equal access to other Social and economic development programs.

We are denied full participation in such important programs as Medicaid, Social Security and the JOBs program, which provide training and child care funds for parents of poor children. In other words, Section 936 is taking money out of Puerto Rico's citizens pockets and replacing those dollars as 936 company profits.

While Congress has denied the 3.5 million U.S. Citizens in Puerto Rico the full participation in these programs, it instead has provided two federal tax credits. Section 936 provides a tax credit for US corporations and Section 933 provides tax exemption for individuals and island corporations.

In doing so, Congress has forced Puerto Rico to follow an economic development program different from the economic strategies by the 50 states, and which has not worked.

LACK OF PROPER HEALTH CARE

As a result of this lack of assistance, the island's health care system is in shambles. We insist that any change in Section 936 must be accompanied by improvements in our health system and assistance to the needy. We don't want you to forget that the taxes that these companies will bring to the United States' treasury will come from business generated in Puerto Rico.

We continue to sustain the following positions on Section 936:

I. 936 IS NOT CRITICAL TO PUERTO RICO'S ECONOMY AND ANY CHANGE WILL NOT CAUSE THE ECONOMY TO COLLAPSE.

Section 936 has existed for almost 25 years and yet, its workers represent a small portion of the Puerto Rican economy. The level of unemployment on the island continues to be a high 18%. Over the last twenty years the rate of unemployment has fluctuated between 13 - 17%. These facts don't speak out in favor of Section 936.

As a matter of fact much of the labor intensive portion of the manufacturing process of 936 companies is now being done through twin plant operations in the Dominican Republic and other Caribbean countries which increases the tax free profit margins for the companies but reduces employment in Puerto Rico.

To sustain our position, we would like to include for the record, the testimony offered to the Puerto Rico Senate on March 3, 1993 by Marcos Rodriguez, President of the Puerto Rico Government Development Bank.

Mr. Rodriguez said: "I can assure you that not even in the worst of cases would the impact be as damaging as the studies that have been done in the past have projected. They all suffer from the same flaw:

They seem to respond to the public and private interests that commissioned the studies and they foresee the disappearance of 100% of direct jobs in 936 companies, and even the indirect jobs. These merchants of doom, who freely make inflammatory statements to the press and legislative committees like this one, are not serving Puerto Rico well."

"The results of our preliminary analysis indicate that more than 75% of the direct jobs in 936 companies would not be affected as a result of a replacement of the existing incentives with a wage credit of at least 65% as proposed by President Clinton."

And he concluded: ".... contrary to what persons and entities may have testified before the committee, Puerto Rico will not sink. And frankly, it doesn't have to get on its knees, either."

II. ALMOST ALL OF THE 936 COMPANIES WILL NOT LEAVE PUERTO RICO IF SECTION 936 IS SIGNIFICANTLY CHANGED.

According to data available from the P.R. Government Development Bank:

a) 37,651 direct jobs, or 36.2 of total employment, are with companies whose tax benefits would not change under the Clinton proposal.

b) 21,258 jobs, or 20.4% are with companies whose tax benefits would be affected by less than 25%.

c) 24,553 jobs, or 23.6% are with companies whose tax benefits would be affected between 25% and 50%.

d) 20,599 jobs, or 19.8% are with companies whose tax benefit would be affected between 50% and 75%.

The truth, Mr. Chairman is that the wage credit proposal will reduce somewhat the extraordinary U.S. taxpayer subsidized profits enjoyed by a few corporations in P.R., and not affect the vast majority of the Section 936 corporations.

Pharmaceuticals are not going to leave P.R.! It would make no business sense to close these facilities down and build entire new facilities elsewhere at a great cost. The Pharmaceutical companies make their investment back after only 15 months and still need to have FDA approval for their products in the U.S.

So, despite the many different voices you will hear today, we all know that change is inevitable, that we live in a new era of change, and that Puerto Rico can not exempt itself any longer from that change. We are ready for that change and grow with the rest of the nation, and addressing the Section 936 issue is a critical first step in the right direction.

Puerto Rico cannot be excluded from national policy debates and then be treated as "special," out of mis-directed paternalism, that tends to condemn the patriotic people of this island to the political and economic twilight zone.

The Clinton Administration and Congress will be doing the right thing by defining a national economic strategy which includes Puerto Rico. That is the promise of America, and the loyalty of U.S. citizens of Puerto Rico to this country includes our belief that the United States of America will keep her promise of democracy and equality.

Mr. Chairman that concludes my testimony. For the record I would like to submit the following additional items:

1. Copy of the testimony of Mr. Rodriguez-Ema's, President of the P.R. Government Development Bank, before the P.R. Senate Labor Committee.

2. Copy of Mr. Peter Merrill's work: The Possessions Tax Credit and Puerto Rican Economic Development.

3. A paper of Mr. Alexander Odishelidze expressing some interesting views on Section 936 which the Committee should consider.

4. A copy of a March 24, 1993 Editorial on Section 936 which appeared in the Washington Post and copy of my response to that Editorial.

5. Newspaper articles which help support our comments.

The Vice President of our organization, Attorney Luis Costas, a foremost expert on Section 936 is available to answer your technical questions.

March 30, 1993.

TO: THE HONORABLE COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES

FROM: LUIS P. COSTAS ELENA, ESQ.
COUNSEL, PUERTO RICANS IN CIVIC ACTION.

RE: SUPPORT FOR THE PRESIDENT'S PROPOSALS FOR PUBLIC INVESTMENT & DEFICIT REDUCTION - REFORM OF I.R.C. SECTION 936.

Puerto Ricans in Civic Action is a civic, non-partisan, grass-roots movement, in Puerto Rico, that has gathered and delivered to the U.S. Congress more than 350,000 individually signed petitions for Puerto Rico to become the 51st State of the Union. We, Puerto Ricans in Civic Action, wholeheartedly support President Clinton's proposals, especially the reform of I.R.C. Section 936 into a wage credit. We hope, however, that the U.S. will move forward to the elimination of I.R.C. Section 936. Accordingly, we also support Senator Pryor's Bill.

Puerto Rico should receive domestic solutions and programs, not tax gimmicks that can only produce resentment in the States, because of Runaway businesses. At the very least I.R.C. Section 936 should have a sunset provision and strict requirements for reauthorization.

For many years we have been pointing out that I.R.C. Section 936 is a scandalous, every-increasing federal tax expenditure, that in effect is a wasteful, federal welfare program basically for pharmaceutical and other Fortune 500 corporations.

I.R.C. Section 936 is extremely perverse, expensive and a tremendous drain on the federal budget. The United States General Accounting Office has calculated that from 1993 through 1997 the United States treasury will lose $15 billion because of I.R.C. Section 936. According to the Puerto Rico Planning Board the estimated number of employees in the entire chemical and analogous products group in Puerto Rico, which includes pharmaceuticals, was at most 22,600 for fiscal year 1991; and such employees are around 2% of the total number of employed persons (925,000) by major industrial sectors in Puerto Rico; yet pharmaceutical corporations pocketed 54% of the Section 936 tax expenditures in 1989 or $1.5 billion of the $2.8 billion in total Section 936 tax expenditures of 1989. In other words, Section 936 is the worst type of welfare, welfare for the extremely rich pharmaceutical corporations, (those that least need federal subsidies and that employ relatively few persons in Puerto Rico), in the expectation that some of those federal subsidies will indirectly to the average Puerto Rican trickle down.

Worse still, Section 936 is a threat to democracy. Section 936 has created powerful, vested economic interests, ever vigilant and protective of their exemption privileges, in Puerto Rico - a small island of insufficient social and political resources to overcome such great concentrations of wealth. Those vested interests cry wolf at any attempted reform or reduction of 936 and consist of the exempt persons - especially the so-called Section 936 corporations; the professionals - lawyers, accountants, consultants and executives - that serve the privileged exempt persons; Fomento; financial intermediaries such as large banks or brokers; and diverse governmental personnel that seek or expect employment or other rewards from said exempt persons, professionals or banks.

Although the supposed justification for Section 936 is the creation of jobs in Puerto Rico, Section 936 has never been tied to such jobs. Section 936 provides the federal subsidy and the exemption on the basis of profits, irrespective of the creation of any jobs or the payment of compensation.

Section 936 and its predecessors 931 and 252 have not reduced unemployment in Puerto Rico. In 1898 unemployment was at 17%, in 1940 at 15% and the latest figures from the Puerto Rico Planning Board report that unemployment still stands at around 17%.

Recently, the Puerto Rico Senate Labor, Veterans Affairs and Human Resources Committee has held hearings on the expected changes to Section 936, and much of the testimony therein, including that of the President of the Puerto Rico Government Development Bank, supports that Puerto Rico will not only not suffer from the proposed reforms but can expect economic progress from the totality of the President's proposals and programs.

The President's package needs and counts on the $7 billion that the reform of I.R.C. Section 936 produces for the budget, a budget that will provide good programs for the United States and Puerto Rico. The Congress can actually advance the President's package and programs by accelerating the reform of 936 - implementing the 65% or lesser wage credit by 1996.

I.R.C. Section 936 is a section of the federal, Internal Revenue Code that allows United States corporations, principally the "Fortune 500" to organize United States subsidiary corporations to do business basically in Puerto Rico. The "Fortune 500" parents then shift profits from their taxable operations in the United States or elsewhere to the Puerto Rican business (that receives Fomento tax exemption in Puerto Rico) and then retrieve those profits plus the tax free investment income generated by those profits almost completely free of both federal and Puerto Rican income taxation either via the 100% intercorporate dividend deduction or a tax free liquidation. The parent companies then commence again this circle of avoidance of federal income taxes by shifting other profit to the Puerto Rican operations. The I.R.C. Section 936 subsidiaries do not pay federal income taxes because they receive a federal income tax credit for taxes that they have never paid. The credit device spares - exempts - the profits covered by the credit from federal income taxation.

In 1991 Merck received $204,375 in federal tax expenditures of 936 per employee; American Home Products $105,600 per employee; Bristol-Myers Squibb $101,904 per employee; Upjohn $133,929 per employee. Obviously, said companies did not pay those amounts in salaries to each one of their employees and not all of those employees were even in Puerto Rico. Many employees were even temporary.

Because of I.R.C. Section 936 the people of Puerto Rico suffer the capping or restriction of five very important social programs: Supplemental Security Income, Aid to Families with Dependent Children, Nutrition Assistance, Medicaid, and Medicare Reimbursement. The federal government cannot uncap or unrestrict these programs in a time of budgetary constraints, when the federal treasury is already hemorrhaging at the rate of around $3 billion every year because of Section 936. Accordingly, the aged, the needy, the blind or otherwise disabled, the dependent children and the nurses, doctors and hospitals of Puerto Rico are sacrificed for the sake of Section 936.

Section 936, moreover, constitutes unfair competition against the States of the Union and injures the workingmen and workingwomen of each of the 50 States - your constituents - by subsidizing businesses that run away to Puerto Rico. As long ago as 1952 Senator Brewster, among other Congressmen, pointed out:

> "A basic fallacy in the whole Puerto Rican industrialization program is the fantastic cost per job. In other words, the program of luring business to Puerto Rico costs millions of dollars in United States taxpayers' money and produces relatively few jobs for Puerto Rican workers."

At present 936 does involve the expenditure of $3 billion in federal funds each year but is an extremely irrational subsidy. According to Professor Stanley Surrey of the Harvard Law School, also former Assistant Secretary for Tax Policy in the U.S. Treasury Department from 1961 to 1969:

> "A dollar is a dollar - both for the person who receives it and the government that pays it, whether the dollar comes with a tax credit label or a direct expenditure label."
>
> "(M)any incentives look, and are, highly irrational when phrased as direct expenditure programs structured the same way."
>
> "(A) resort to tax incentives greatly decreases the ability of the Government to maintain control over the management of its priorities."
>
> "(T)ax incentives do involve expenditures - 'back-door expenditures' ... abd ... a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the back door."

The time to change and reform is long overdue and is now.

Mr. RANGEL. Thank you.
Dr. Munoz.

STATEMENT OF ERIC MUNOZ, M.D., CHAIR, PUBLIC POLICY COMMITTEE, NATIONAL PUERTO RICAN COALITION, INC., ACCOMPANIED BY LOUIS NUNEZ, PRESIDENT

Dr. MUNOZ. Mr. Chairman, I am Dr. Eric Munoz. As you recall, your personal surgeon at one time in the great city of New York, at the Metropolitan Hospital Center. Good morning and good morning to the rest of the members of the committee.

I am here representing the National Puerto Rican Coalition. I am chairman of their Public Policy Committee, and I would like to give our views on the proposed changes.

Mr. Chairman and members of the Committee on Ways and Means, I wish to thank you for allowing me to testify today with the National Puerto Rican Coalition's views on the current proposals.

The National Puerto Rican Coalition is a membership association composed of over 500 Puerto Rican communities and organizations. Its goal is to further the Puerto Rican people.

As a physician and surgeon who now works in New Jersey on the frontline, I am the head of a large hospital in Newark. I would like to give my perspective on the potential effect of these proposals on the U.S. cities, in particular, mainland cities.

Right now, besides being a surgeon, I interact with all the various sectors—education, economic, public, and private. I sit on many different planning committees, the Boys Scouts, United Way, and I believe that we must consider that we have a very fragile situation in many American cities that will be eroded by these tax proposals.

Remember, Puerto Rico is a United States Commonwealth and, as U.S. citizens, there is a tremendous interaction between the Puerto Rican population on the island and the mainland United States. Many of the members of this committee sit in Federal districts, whether it be New Haven, Connecticut, New York, Newark, Chicago, Illinois, Philadelphia, there are many cities, and smaller cities, too, that have fairly substantial Puerto Rican and Hispanic populations.

This Puerto Rican population has a tremendous migration between the island and the mainland. If there is an adverse situation on the island of Puerto Rico, it is likely that many of these citizens will take a plane ride, and migrate into American cities. I think we must carefully think about the impact of this on health, on education, on employment, on the criminal justice system of U.S. cities. I know that the Clinton administration is trying to reverse the decline of U.S. cities, and not implement a policy with a serious domino effect, that can really have a very deleterious effect on the mainland.

While the situation confronting the Puerto Rican economy and the Puerto Rican people is truly unique, Puerto Ricans, like the rest of Americans, support the administration's efforts to solve the problems of our Nation. We are prepared to share in this challenge. However, this proposal will have a substantially deleterious effect on both the island and the mainland.

That will be translated into not only a loss of many jobs, and no one knows the exact number, but it is being bandied at 200,000 to 300,000. There will also be a domino effect of job loss on the mainland of somewhere about 200,000 jobs from industries that support the island or related to the island economy.

Then, with the migration back and forth, this policy is likely to have a substantial impact on transfer payments and on social institutions, such as health and education, in our U.S. cities. I think, in the aggregate, although there has not been a modeling of what the aggregate costs would be, these costs are likely to be far in excess of the $7 or $8 billion that has been purported to be saved by this proposal.

I would like to submit written testimony which outlines our position exactly. In summary, section 936 has accomplished what the authors intended, creation of a modern technological economy for Puerto Rico and significant improvement of the socioeconomic status of the Puerto Rican community on the island and on the United States mainland.

All of you who have traveled to Puerto Rico know that it is really a model for the Caribbean, and this would not have occurred, I believe, without substantial assistance from 936, such as has been given over the last 20 to 30 years.

We believe at the National Puerto Rican Coalition that President Clinton's economic plan will help this country move forward by controlling the deficit, but at the same time should not be disproportionately deleterious to any one group. And we feel that the current proposal would be very deleterious to the Puerto Rican population.

We ask you, Mr. Chairman and members of the committee, to keep in mind that any changes in section 936 must consider the unique status and fragility of the Puerto Rican economy, plus the relationship to the mainland, particularly to U.S. cities.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF DR. ERIC MUNOZ
CHAIR OF PUBLIC POLICY COMMITTEE
NATIONAL PUERTO RICAN COALITION
HEARINGS ON PRESIDENT CLINTON'S ECONOMIC PLAN
COMMITTEE ON WAYS AND MEANS
APRIL 1, 1993

Mr. Chairman, and members of the committee on Ways and Means, I wish to thank you for allowing me the opportunity to provide you with the National Puerto Rican Coalition's view of President Clinton's economic proposal and the possible impact of the package on the Puerto Rican community. The National Puerto Rican Coalition is a membership association composed of over five hundred Puerto Rican community- based organizations and leaders. NPRC's goal is to further the social, economic and political well-being of the more than six million Puerto Ricans throughout the United States and Puerto Rico.

To begin, I would like to make six brief comments about the Puerto Rican community:

1. Puerto Ricans, both in the mainland and on the Island, are United States citizens. Puerto Rican jobs are American jobs;

2. As United States citizens, Puerto Ricans migrate freely between the mainland and the Island -- maintaining close familial and economic ties to each;

3. There is a strong interdependence between the Island and the mainland. The viability of the Puerto Rican economy strongly affects the US mainland economy;

4. Puerto Ricans, as loyal and patriotic citizens, have served in every war since World War II, with disproportionate representation when compared to the US general population in the Vietnam and Persian Gulf wars;

5. Ninety five percent of all mainland Puerto Ricans live in urban areas and 75% live in central cities, representing the most urbanized ethnic group in the US; and

6. Puerto Ricans are nearly three times as likely to live in poverty, drop out of high school at a rate exceeding 50% in some major cities such as New York and Boston, have home ownership rates that are one-third the national average, and suffer from AIDS and substance abuse in extremely high numbers when compared to the general population.

While the situation confronting the Puerto Rican economy and Puerto Rican people is truly unique, Puerto Ricans, like the rest of Americans, support the administration's efforts to solve the problems of our nation. Puerto Ricans are prepared to share and contribute to the national effort to help the economy because we believe that the entire nation will benefit from the implementation of the President's proposal. The Puerto Rican community is indeed willing to sacrifice along with the rest of the country, but not if a disproportionate share of the burden is given to the Puerto Rican people.

The benefits of the administration's proposals for the Puerto Rican community lie in a number of different policy areas. Specifically, we support President Clinton's proposal for full funding of Head Start and a change in the student loan program for college students. We endorse welfare reforms that account for the cultural uniqueness of the Hispanic communities, and support programs which benefit low income Americans.

NPRC is also fully supportive of higher authorization levels for childhood vaccinations as well as full funding of the Ryan White AIDS legislation. And, additional funding to enforce the Civil Rights Act, which the administration proposes, has been long overdue. Finally, President Clinton's proposed changes in the areas of housing and community economic development will also benefit the Puerto Rican community, particularly those efforts which recognize and incorporate the success with which community-based organizations have initiated and instituted development at the local level.

While we endorse the President's economic package as a whole, we are deeply concerned about the provision that would reduce the benefits granted to Puerto Rico under Section 936 of the Internal Revenue Code without offering any viable economic alternatives to the Island. To quote a recent *Washington Post* editorial, we are concerned by his "half a Puerto Rican policy."

Section 936 and the previous provision in Section 931 have clearly moved Puerto Rico from its status as "the poor house of the Caribbean" to the most prosperous economy in Latin America, despite the fact that per capita income on the Island is still half that of the poorest state. Any attempt to repeal or curtail Section 936 benefits without offering comparable economic incentives would adversely affect Puerto Rico's economy.

The administration's proposal that has been put forth would cap the tax credit that Section 936 companies receive to 65% of wages paid to their employees. The tax credit would only extend to wages paid by employers of up to $60,000.

As it stands, the President's proposal will have a devastating effect on Puerto Rico's workforce. According to recent studies, Section 936 companies directly generate about 115,000 jobs on the Island while indirectly promoting another 200,000 jobs. These 300,000+ jobs represent a third of all the jobs in Puerto Rico. The economic development strategy of Puerto Rico based on tax incentives such as Section 936 has created a significant middle class comprised of managers, engineers, bankers, accountants and entrepreneurs operating small and medium size businesses which serve the needs of 936 corporations. Despite such benefits, Puerto Rico's current unemployment rate is estimated at 18.1%, up 3.3% from December of 1992, a figure which is more than double the stateside level. Coupled with an increased level of investment risk, any attempt to reduce incentives to the companies that provide these jobs in Puerto Rico without offering a viable economic alternative would further cause a surge in unemployment.

Contrary to President Clinton's commitment to present a tax plan which will have a minimal impact on American families with less than a average incomes of $30,000, the 936 provision of his plan will have a major impact on a society where the vast majority of families have incomes significantly below this level. Further, President Clinton is committed to reducing the high unemployment level facing Americans today. We must continue to reinforce the fact that Puerto Ricans on the Island and the mainland are Americans and deserve the same consideration as everyone else.

In addition, Section 936 benefits ripple throughout all sectors of Puerto Rico's economy. There are stipulations in the law that enable profits earned by U.S. subsidiaries in Puerto Rico to be deposited in the Island's banks in order to keep the cost of credit in the region low. The so-called "936 funds," which are estimated to be over $12 billion, are a vital source of capital for projects in Puerto Rico and elsewhere in the Caribbean. Funds from both Section 936 and the Caribbean Basin Initiative have promoted economic

growth and stability in the Caribbean, and have resulted in an increased flow of trade and investment between the US and the Caribbean Basin. Any increases in credit costs will lead to downsizing in certain sectors of these economies. We would like to see an arrangement similar to the one between Section 936 corporations and the Caribbean nations implemented here in the United States between 936 corporations and impoverished communities on the mainland.

A wage-based tax credit, such as the one proposed, is earmarked for manufacturing industries that provide many jobs at low wages. Essentially, those companies that have total nominal wages at levels close or equal to the companies' annual income will not be affected by the proposed change. However, those low wage companies are gradually becoming a small portion of 936 corporations. In fact, in the past decade, Puerto Rico has been moving away from a low-wage manufacturing base to more capital-intensive industries with high technology jobs. Thus, the President's proposal seeks to promote low-wage industry development in Puerto Rico without taking into account that many low-wage industries have already left Puerto Rico due to some competitive shortcomings, such as high transportation and energy costs, and increased global competition. These are factors that cannot be offset by a wage credit.

Since the 1970s, the overall gain in jobs in Puerto Rico has come from high-skill, capital-intensive, low labor industries such as instruments and related products, and chemicals and allied products, which has overcompensated for the downturn in employment that has come from labor intensive industries such as apparel and other textile products. Curtailing incentives on income and investment to these former industries that invest large amounts on research and development, machinery and equipment, and high paying jobs would seriously cripple Puerto Rico's economic expansion in these industries of the future.

We also feel that the proposed change in Section 936, and its impact on the employment of Puerto Ricans on the Island, might trigger a new exodus of Puerto Ricans seeking jobs in the United States. Since the 1940s, it has been estimated that at least one-third of Puerto Rican Islanders have left Puerto Rico in search of better economic opportunities in the mainland. A future mass exodus of Puerto Ricans from the Island may further strain the already depressed local economies of the mainland's northeastern inner cities where Puerto Ricans reside, cities that offer little with respect to job opportunities for their underserved populations. There will also be an increased need for federal transfer payments to compensate for joblessness in Puerto Rico.

There are more than 700 Section 936 companies in Puerto Rico which have helped the Island become the tenth largest purchaser of goods and services from the mainland with $11 billion in purchases in 1991. These purchases are estimated to support some 220,000 mainland jobs. If the President's proposal is enacted, the mainland U.S. economy will suffer from a decrease in trade with Puerto Rico and eventually a loss of mainland jobs. The US Merchant Marine might be most affected since they rely heavily on trade with the Island. In FY 1991, trade carried by US vessels to and from the Island accounted for 33% of all domestic shipments.

For example, according to a recent survey of 50 Section 936 corporations with operations on the Island, a total of $2.3 billion in materials and services in 1991 were purchased from mainland suppliers, generating an estimated 46,000 jobs on the mainland. These companies have a heavy trade relationship with states with large Puerto Rican populations. For example, in 1991, Section 936 companies in Puerto Rico purchased $382 million worth of goods and services from the state of Illinois; $222 million from New Jersey; $204 million from Pennsylvania; and $195 million from New York.

In our opinion, Section 936 has accomplished what its authors intended: creation of a modern, technological economy for Puerto Rico and significant improvement of the socio-economic status of the Puerto Rican community on the Island to bring it closer to levels in the US mainland.

We at NPRC believe that President Clinton's economic plan will help this country move forward by controlling the deficit while at the same time investing in our nation's human capital. However, to place Puerto Rico at a disadvantage at a time when its economic future is already threatened by disinvestment and a free trade agreement that encompasses all of North America, without offering any viable alternatives to the development of an advanced economy, is unfair.

We ask you, Mr. Chairman, and members of the committee, to keep in mind that any changes in Section 936 tax credits must consider the unique status and fragility of the Puerto Rican economy as well as the need for a phase-in period to reduce the economic damage to the Island and the United States mainland. Thank you.

Mr. RANGEL. Thank you, doctor.
Mr. Leonard.

STATEMENT OF RICHARD W. LEONARD, DIRECTOR, SPECIAL PROJECTS, OIL, CHEMICAL & ATOMIC WORKERS INTERNATIONAL UNION, AFL–CIO

Mr. LEONARD. Thank you, Mr. Chairman.

My name is Richard Leonard. I am representing the Oil, Chemical & Atomic Workers Union. We are an organization of 100,000 members, including 10,000 members in the pharmaceutical industry. We appreciate the opportunity to be able to testify today on the possession's tax credit.

First of all, I would like to say that we are in complete support of the President's program for amending section 936. We find that it would raise something like $7 to $8 billion over the next 5 years, which is roughly 40 percent of the $18 billion which is predicted to be lost over the next 5 years to the Treasury because of this tax credit.

The President's program is an extremely modest program. Of course, if you are a member of the pharmaceutical industry, it is not modest, but it is a modest program, in our view, that is targeted really at a couple of very powerful special interests, pharmaceuticals and others who are immensely enriched by this tax break and provide relatively little employment in the Commonwealth. It also, I believe, does not really do away with section 936, but reestablishes 936 in the spirit in which it was originally intended.

I think the real debate today is whether or not a few very powerful special interests can demand that the American taxpayer pick up more than 65 percent of their wage bill in Puerto Rico. In view of this, we find the President's proposal courageous and quite gutsy, and we think it is the right thing to do.

In his State of the Union Message, the President declared that "the Tax Code should not express a preference to American companies for moving somewhere else, and it does in particular cases today." This expression illuminates a cruel irony associated with section 936, and that is that in some cases it expects taxpayers to literally put their jobs on the line and to risk export of their jobs to Puerto Rico.

In fact, taxpayers are financing a sort of lottery, where the winning entries are pink slips. This is true, of course, for the Acme Boot Co., where 480 workers in Clarksville, TN, are seeing their plant leave for Puerto Rico. They are going to be losing their jobs in May. This is true for 281 workers in Palo Alto, CA, at the Syntex Co. who is relocating its facility to Puerto Rico. And this is additionally true for 200 workers with the Sundstrand Co. in Brea, CA, who are facing job loss as a result of that company's migration to Puerto Rico.

This whole process is best illustrated by that of the American Home Products Corp., which is one of the largest companies in the world making pharmaceuticals. More prescriptions are written on this company's drugs than any other. It is one of the most profitable companies. They established themselves in Puerto Rico in 1985. By 1991, this huge company had transferred 42 percent of its worldwide income producing capacity into that Puerto Rico shelter,

gaining a subsidy in 1991 of $75,000 per year per job. At the same time, U.S. employment fell from 27,000 to 25,300. At the same time, they were closing facilities in Elkhart, IN, and Great Valley, PA, and 1,300 people were displaced.

The 936 lobby has not admitted to a single tax-driven dislocation of one mainland worker. They are in a complete state of denial. Yet, on the other hand, they are saying that they would instantly bolt Puerto Rico and lay off tens of thousands of workers, if they had to accept the Clinton program. This very same group who is saying they would never dislocate a mainland worker to go to Puerto Rico to take advantage of a 246-percent wage credit is now saying they would dump tens of thousands of workers in a heartbeat, to get better than a 65-percent wage credit somewhere else. This whole argument to us is quite preposterous. There has been tax-financed exports of jobs from the mainland.

Given, however, the generosity of the Clinton proposal, we are concerned, however, that there will be more Clarksvilles, there will be more Elkharts, there will be more Brea, Californias and more Palo Altos, more closures as a result of this tax policy. Clearly, such an outcome is not intended by the Clinton administration.

For these reasons, we support passage of legislation to stop the export of jobs, the tax-financed export of jobs. There are two bills I would like to refer you to, H.R. 1210 and H.R. 1207, which have been sponsored by Representative Stark of this committee and co-sponsored by Representative Roemer of Indiana, that will address and prevent the tax-financed export of jobs under section 936.

In conclusion, I would like to note that the Members of Congress have a unique opportunity this year to perform a great service to workers, by supporting passage of H.R. 1210 or H.R. 1207, and holding firm on the President's 65-percent wage credit program.

Thank you very much.

[The prepared statement follows:]

STATEMENT BY RICHARD W. LEONARD, SPECIAL PROJECTS DIRECTOR OIL, CHEMICAL AND ATOMIC WORKERS INTERNATIONAL UNION BEFORE THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES CONCERNING PRESIDENT CLINTON'S ECONOMIC PLAN AND SECTION 936 OF THE INTERNAL REVENUE CODE APRIL 1, 1993

My name is Richard Leonard. I am the Special Projects Director for the Oil, Chemical and Atomic Workers Union (OCAW). The OCAW is a labor union which is affiliated with the AFL-CIO and represents over 100,000 workers in the energy and chemical industries, including about 10,000 workers in the pharmaceutical industry.

OCAW appreciates this opportunity to express its views on the President's proposal for capping Section 936 tax credits by the equivalent of a 65 percent credit on wages paid in U.S. territories.

Let me begin by stating that we are in complete support of President Clinton's program for reforming Section 936. This program will raise between $7.0 and $8.3 billion over the next five years that can be employed to reduce the deficit, or strengthen desperately-needed social programs. The best news is that these new revenues will not come at the expense of important social programs or of the poor, the disadvantaged, our nation's children or others who lack the strength to exercise the levers of power. Instead, this new revenue will come from the simple act of asking a narrow group of immensely wealthy special interests to turn in their keys to the Federal Treasury.

Section 936, otherwise known as the Possessions Tax Credit, was originally designed to encourage economic development and job creation in the Philippines. Today, virtually all of total Possessions Tax Credit is claimed by companies doing business in Puerto Rico.

Of the 105,500 manufacturing jobs directly promoted by Section 936 in Puerto Rico, 50,500 of these jobs are subsidized at an annual cost of about $384 million. While this amounts to an average annual federal subsidy of about $6,564 per job per year, this may not be unreasonable considering the economic conditions that have existed there. Section 936 companies in this category are typically involved in the manufacture of apparel, food products, plastics, leather, and other labor-intensive industries.

However, a few industries, including pharmaceuticals, electronics and instruments, along with two beverage companies, have mangled the intent of Section 936 by extracting for themselves an enormous Federal subsidy while providing relatively few jobs. In particular, 57 pharmaceutical companies employing no more than 17 percent of the entire Section 936 manufacturing workforce in Puerto Rico, have captured nearly 55 percent of the Section 936 tax credit. These 57 companies take 936 tax credits equivalent to $85,316 per year for each worker employed in Puerto Rico at an annual cost to the U.S. Treasury of $66,140 per worker.

These companies have reshaped the Possessions Tax Credit to allow businesses to transfer valuable intellectual property rights and other intangibles into Puerto Rico shelters without an arm's length transfer of value. In this way, high profits normally earned on such intangibles become super profits beneath a territorial tax shelter. And because these super-profitable rights and patents are largely owned by the pharmaceutical industry, it is this industry

that has been the largest beneficiary of Section 936 tax credits. Thus, a tax law that was originally designed to reward job creation has been distorted by a few special interests to reward profit creation.

From a revenue standpoint, the President's 65 percent wage cap on Section 936 benefits would recapture approximately 40 percent of the $18.7 billion that would be lost to the U.S. Treasury over the 1994-1998 time period. It is targeted directly at those relatively few companies which have acquired enormous wealth at the expense of mainland taxpayers, while contributing comparatively little to the economy of Puerto Rico. At the same time, it effectively exempts the bulk of 936 companies who have contributed the most to Puerto Rico's economy. Clearly, the Administration's 65 percent wage credit does not do away with Section 936, but seeks to reestablish this tax incentive in the spirit in which it was originally created.

It is important to note that even in the complete absence of any wage or tax credit, the cost of wages paid is deductible against earnings. At the current statutory rate, most Section 936 companies already receive the equivalent of a 34 percent wage credit. Thus, the Administration's proposal, in this sense, comes close to creating a 100 percent subsidy for wages paid by 936 companies.

Under these, or any other circumstances, the President's proposal for Section 936 is extremely generous. With the growing federal deficit and pressing social matters throughout society, it would seem foolhardy, if not extraordinarily dangerous, to expect mainland taxpayers to pick up more than 100 percent of a Section 936 company's payroll costs.

The Administration's program recaptures enormous lost revenues while at the same time giving generous consideration to the special circumstances in Puerto Rico, which, for years, has experienced unemployment in excess of 15 percent and a standard of living that is less than one-half of that enjoyed by citizens on the mainland.

For these reasons, we strongly encourage Congress to resist any attempt to dilute the President's wage credit formula. To ask the American taxpayer to subsidize more than 65 percent of the wage bill for these companies would be unconscionable. Given the enormous economic and political resources of the few but very muscular special interests vested in the status quo, President Clinton's proposal is courageous and gutsy. And it is the right thing to do. It is our hope that the members of this Committee and this Congress will follow the President's example and his leadership.

President Clinton is also to be commended for his recognition that Section 936 has had a destructive effect on jobs and the welfare of working people on the mainland. While campaigning last Fall, President Clinton and Vice President Gore were quick in their expressions of outrage and in their promises to end the practice of using <u>tax dollars</u> to subsidize the destruction of jobs belonging to <u>taxpayers</u>.

During his State of the Union message, President Clinton directly addressed this issue. He declared on February 17, 1993: "Our plan seeks to attack tax subsidies that actually reward companies more for shutting their operations down here and moving them overseas than for staying here and reinvesting in America...the tax code should not express a preference to American companies for moving somewhere else, and it does in particular cases today." The President followed up this statement with a proposal to sharply curtail Section 936.

President Clinton's remarks illuminate the cruel irony involved in Section 936. The very group of middle Americans who are financing

Section 936 with their tax dollars are unwittingly buying into a lottery where the winning entries are pink slips.

At this very moment, 480 workers at the Acme Boot plant in Clarksville, Tennessee, are being thrown into area unemployment lines, while their employer transfers machinery, raw materials and jobs to Section 936 facilities in Puerto Rico.

At this very moment, the Syntex Corporation is undertaking the closure of its only mainland pharmaceutical plant in Palo Alto, California. The company has announced that it intends to transfer all pharmaceutical operations to facilities in Puerto Rico, thereby displacing 281 Bay Area workers.

At this very moment, the Sundstrand Corporation is laying off 200 workers as it transfers jobs from its Brea, California facilities to a location in Santa Isabel, Puerto Rico.

And, at this very moment, the Colgate-Palmolive Corporation has issued notice that it intends to dislocate over 200 workers at its Kansas City, Kansas plant. This plant has manufactured Colgate toothpaste, as well as various liquid cleansers, which are now manufactured in a new plant staffed by 150 workers in Guayama, Puerto Rico.

The magnitude of this problem is illustrated by a visit undertaken by our union to the town of Guayama on the southern coast of Puerto Rico. We were there for the purpose of inspecting several plants owned by the American Home Products Corporation (AHP). The two plants owned by AHP subsidiaries, Ayerst-Wyeth Pharmaceuticals, Inc. and Whitehall Laboratories, were at that time the subject of a lawsuit alleging the displacement of approximately 1,300 mainland workers at shuttered locations in Elkhart, Indiana, and Great Valley, Pennsylvania.

Immediately adjacent to these facilities, we came upon a third facility owned by the BOC Group and operating under the name of Anaquest. This facility had expanded in 1987 to accommodate a transfer of work from a similar facility in Cleveland, Ohio, resulting in the displacement of 50 OCAW members in that community. Down the road a few miles, we found a plant owned by Colgate-Palmolive in Puerto Rico whose 150 employees manufacture toothpaste and liquid soap products, both of which had formerly been manufactured in Kansas City, Kansas.

Finally, we happened across a plant owned by SmithKline Beecham that had absorbed 300 jobs from a now-vacated square block facility in downtown Philadelphia. To put it bluntly, Guayama is, in our view, a fat farm for the pharmaceutical companies where this industry can feast on a steady diet of tax breaks, if not members of our union.

The pharmaceutical industry is, and has been, the most financially successful major industry in America. The pharmaceutical industry ranks <u>first</u> among all industries in the <u>Fortune 500</u> in return on sales. It ranks <u>first</u> in return on assets. And, it ranks <u>first</u> in return on equity. Year after year, the pharmaceutical industry has distinguished itself as one of the very few recession-proof industries in the U.S.

Over the last 25 years, this industry's patents, plants and production jobs have run for cover beneath the 936 tax shelter. In this way, the 936 tax credit has operated powerfully to cause the massive relocation of the pharmaceutical industry's most productive capacity to Puerto Rico. By 1990, 17 of the most prescribed drugs in the U.S. were authorized for manufacture in Puerto Rico.

With this relocation of patents, plants and profits, there has come a substantial relocation of jobs and an equally substantial

dislocation of mainland workers whose tax dollars have largely financed this scheme.

This process is best illustrated by citing the example of the American Home Products Corporation.(1)

American Home Products (AHP), is one of the nation's leading pharmaceutical manufacturers earning $1.4 billion in profits on sales of $7.1 billion in 1991. In 1985, AHP commenced production of pharmaceuticals in Puerto Rico. Seven years later, AHP had established the largest single pharmaceutical operation in Puerto Rico and had racked up over $550 million in 936 tax savings. AHP saw its effective tax rate fall from 44 percent in 1984 to 34 percent after tax reform in 1986; then to 27 percent after its acquisition of the A.H. Robins Company (and $2 billion in net operating losses), and, finally, to 22 percent as a result of 936 tax credits on its earnings in Puerto Rico.

In 1991, AHP earned $580 million in after-tax profits in Puerto Rico, including $106 million in 936 tax savings. <u>It had, in the short span of seven years, relocated 42 percent of its worldwide income-producing capacity beneath this tax shelter</u>. With approximately 1400 employees in Guayama, Puerto Rico, and 120 employees in a 936-subsidized complementary plant in the Dominican Republic, the 936 tax credit represents a tax-financed subsidy of $68,387 per job. During this seven-year period, U.S. employment at AHP fell from 27,000 to 25,300. Pharmaceutical manufacturing plants in Elkhart, Indiana, and Great Valley, Pennsylvania, were closed or phased down, and over 1,300 mainland workers displaced.

In 1991, the OCAW asked the Midwest Labor Center for Labor Research (MCLR) to examine the possibility that the situation with American Home Products was not an isolated case. This inquiry revealed 25 examples where Section 936 tax credits were a motivating factor in mainland plant closures or mass layoffs.(2) These 25 cases involved a total of 11,008 jobs. Of the 11,008 jobs identified in these 25 cases, 7,306 were directly shifted to Puerto Rico; 995 were transferred to other locations, and 2,707 were transferred to various locations, but where Puerto Rico was listed as receiving an unspecified number of these jobs. Sixteen of the 25 cases involved the pharmaceutical or medical products industry, and most of the cases dated from 1985 or later.

This report by no means resembles an exhaustive search for all such runaways but simply catalogues those situations where relocation to Puerto Rico was noted by corporate officials, the media or the labor union involved. In the vast majority of cases, it is our impression that companies have taken some care to conceal the magnitude of their relocation plans. Most relocations are not difficult to conceal. In large part, the companies taking advantage of Section 936 are <u>Fortune 500</u> companies, with many mainland facilities. Typically, when establishing itself in Puerto Rico, or in any other tax shelter for that matter, a large company will cream off those products from its various mainland locations that offer the highest rate of return. In this way, many mainland facilities may only be slightly impacted. Once the Puerto Rico facility is well-established, the company will undertake a "review" of its mainland facilities and issue a finding that it has "excess capacity" on the mainland, and, in order to remain competitive, the company must "consolidate." A mainland plant is targeted for closure and its work is farmed out to other mainland facilities. In this way, workers and communities who are impacted are often completely unaware of the underlying causal effect of Section 936.

The majority of companies mentioned in the MCLR report have taken the position that mainland plant closures and layoffs were a result of necessary "restructuring and consolidation," without noting that such restructuring always results in an enlargement of Puerto Rico operations and diminished operations on the mainland.

It is our belief that many more examples of this complex process of relocation exist and that the locations represented in the MCLR study represent but the tip of the iceberg.

It has been suggested that such mainland closures, while tax-driven, were undertaken as a result of competitive pressures. They maintain that the plants would have closed anyway, or would have located to other tax havens or low-wage areas if it had not been for Section 936 tax credits. While this is pure speculation, such reasoning fails to appreciate the desperation of workers, who, faced with the oblivion of unemployment, couldn't give a damn about the distinction between Puerto Rico, or Mexico, or Ireland, or Singapore. The point here is that given a choice between a possible mugging on foreign soil and the absolute certainty of a government-financed mugging in Puerto Rico, workers will throw their lot to Singapore in a heartbeat.

PRUSA has, on a number of occasions, represented that Section 936 has created tens of thousands of direct and indirect jobs in Puerto Rico. These assertions, however, overlook and ignore the economic impact of direct and indirect job losses on the mainland that have resulted from the tax-driven export of mainland jobs to Puerto Rico.

In the study referenced above, MCLR estimated that the ripple effects of 7,306 direct job losses account for at least 14,600 to 21,900 indirect jobs lost, as well. When the figures for direct job losses and estimated indirect job losses are added together, we derive a conservative figure for total job loss due to transfers of work to Puerto Rico of between 21,900 and 29,200 jobs.(3)

Additional evidence of job shifting in the pharmaceutical industry is provided in the table (appended to this statement) which compares the growth in production worker employment on the mainland with that of Puerto Rico. As the table demonstrates, production employment in the Puerto Rico pharmaceutical industry has increased by 88 percent during the past decade, rising by 6,600 workers between 1980 and 1991. During the same time period, mainland production employment declined by 6.9 percent or 6,100 jobs.

The pharmaceutical industry, as well as responsible Commonwealth officials, have turned a deaf ear to our concerns over the export of mainland jobs. At the present time, these parties are in a complete state of denial. They refuse to admit that there is any problem whatsoever, and, in fact, continue to maintain that 936 has had the opposite effect of actually creating new jobs on the mainland.

In a March 1993 study, PRUSA maintains that Section 936 companies in Puerto Rico have actually created 46,000 indirect jobs on the mainland as a result of their purchases of goods and services. This logic is spurious for a number of reasons. Clearly, 936 companies would have had an even greater impact on mainland employment had they stayed on the mainland, or at least a similar effect if they had gone to Mexico or Ireland or Canada.

In an effort to quell rising support for the Clinton plan to cap 936, the pro-936 lobby has launched a program based on fear and hysteria. The pharmaceuticals and their friends have spent hundreds of thousands of dollars financing lavish public relations campaigns, asserting that any modification of Section 936 would cause massive unemployment, and higher rates on consumer loans and mortgages. The pharmaceuticals are literally holding Puerto Rico hostage to exaggerated fears of high interest rates, tighter credit and looming unemployment.

For example, in an interview with the Wall Street Journal reported on February 26, Daniel Lebron, President of the Puerto Rico Manufacturers Association, and President of Monsanto's Searle & Co. pharmaceutical unit in Puerto Rico, stated that the Clinton plan

"would be a disaster for Puerto Rico." He went on to say that if Section 936 were replaced by a wage credit, in 10 years the island's high-technology industrial base will be "20 percent of what it is now." Similarly, PRUSA claims that, "a wage credit substitute for Section 936 will result in the loss of tens of thousands of manufacturing jobs on the island."

Such dire predictions seem to emanate from a narrow but powerful group of mainland-based pharmaceutical companies and banks that stand to lose ground under the wage credit plan. These predictions differ markedly from those of people in positions of responsibility in Puerto Rico:

> "High-technology industries would be adversely affected by [the wage credit], but they won't really leave the island."
>
> > John Stewart, economic advisor to the Puerto Rico Economic Development Agency, Fomento; San Juan Star, February, 24, 1993.

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> "The effect of President Clinton's proposal to cap 936 would be "manageable" for domestic banks, as these banks only have about 17.4 percent of total 936 deposits."
>
> > Marcos Rodrigues Ema, President of the Puerto Rico Government Development Bank; San Juan Star, March 3, 1993.

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> "Going to Washington to say that 936 can't be touched because Puerto Rico will sink is a barbarity."
>
> > Ivar A. Pietri, former Executive Vice President of the Puerto Rico Development Bank; San Juan Star, February 25, 1993.

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> "This take no prisoners attitude on the part of the pro-936 people is not helpful, and it is not realistic."
>
> > Kenneth McClintock, Senator-at Large, and chair of a Puerto Rico Senate fact-finding committee on 936; Caribbean Business, February 25, 1993.

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> "It does no good to exaggerate and cause panic over what is happening."
>
> > The Hon. Carlos Romero Barcelo, Resident Commissioner, and member of Congress from Puerto Rico; San Juan Star, February, 27, 1993

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As a final footnote to threats and dire predictions, it should be noted that the very first company to say that it had scrapped plans to build in Puerto Rico, due to the "uncertainty" of Clinton's proposal, is Ciba Geigy, headquartered in Summit, New Jersey. Ciba Geigy did not choose, however, to take its new $100 million plant to Mexico or Singapore, but chose instead to build right at home at an existing site in Suffern, New York.

The pharmaceutical industry and its friends have not yet admitted to the tax-driven dislocation of a single mainland worker. This is a monument to their arrogance, if not their fear of yet another lawsuit. This total and complete state of denial is utterly

contradicted by their predictions that the imposition of the Clinton wage credit would cause them to bolt Puerto Rico for sunnier tax climes, summarily dumping "tens of thousands" of Puerto Ricans into the unemployment line.

The very companies that said that they <u>have never</u> dislocated a single <u>mainland worker</u> to take advantage of what amounts to a 246 percent wage credit presently offered in Puerto Rico, are <u>now</u> saying that they would dump 300,000 Puerto Ricans in a heartbeat to find something better than the 65 percent wage credit.

In an effort to deflect rising anger over the tax-financed export of jobs to Puerto Rico, proponents of Section 936 have accused mainland labor unions of "singling out" and "bashing" Puerto Rico. They complain that mainland labor unions are zeroing in on Puerto Rico as if it were not a part of the United States. This needs to be addressed.

Puerto Rico, like other states and regions within the U.S., competes for jobs and industries using a variety of incentives. The lack of a national industrial policy allows any state to use its public treasury to subsidize incoming businesses with lower taxes, free improvements, free land, low-cost loans and other enticements, without any consideration for the consequences to another state that must shoulder the subsequent costs of unemployment, poverty, a declining tax base and other aspects of abandonment.

So, why then, are unions devoting so much of their attention to Puerto Rico?

Nowhere in this bidding war for ever-greater tax-financed giveaways to industry does the U.S. Federal Tax Code take sides in the battle among the states for jobs and industry. The tax code is applied evenly among all individuals in all states, and cannot be altered in one state to the advantage of another. <u>This is precisely why Section 936 of the Federal Code would be nullified by the entrance of Puerto Rico as a state of the Union.</u>

Moreover, where federal tax <u>receipts</u> are used by states to offer direct incentives to a company, it has been the policy of the federal government to require the recipient to certify under oath that the subsidized project will not adversely affect employment in other regions of the country. This is true of Job Training Partnership Act grants offered by the Labor Department, Economic Development Administration grants offered by the Commerce Department, and Urban Development Action grants of the Department of Housing and Urban Development.

Because of the special tax status of Puerto Rico, an anti-runaway policy has long been reflected within the Puerto Rico tax code. Understanding that Section 936-type credits would be without value in the absence of corresponding exemptions provided by Puerto Rico within its own tax jurisdiction, it was recognized that similar non-relocation declarations would be necessary to blunt the threat of "runaways" and preserve this special status as well as the underpinnings of Operation Bootstrap. And, it has since been recognized that such restrictions on 936-type corporations are necessary to bring Puerto Rico policy into line with Federal policy on tax-financed industrial incentives.

Sadly, in its zeal to expand the package of promotions and giveaways to business, the past administration in Puerto Rico discarded this history and its expression in policy. In our opinion, they encouraged companies to falsify non-relocation declarations required under the Puerto Rico Tax Incentives Act,as well as by the U.S. statutes governing Labor and Commerce Department training and development grants. In this way, "Operation Bootstrap" evolved into "Operation Booted Out."

The fact is, a uniform federal tax policy, coupled with non-relocation restrictions, are presently the law of the land for everyone but Puerto Rico when it comes to the collection and expenditure of federal tax dollars.

Puerto Rico has been the subject of so much attention because of its singularly unique status within the U.S. Tax Code and its rejection of long-standing policies against federally subsidized relocation incentives. What is more, it has been the subject of attention because of the enormity of the subsidy. Whereas a mainland corporation faces a 34 percent U.S. corporate income tax on earnings in any state, it is offered a free ride in the Commonwealth of Puerto Rico. This is why Senator Pryor has named the Possessions Tax Credit, "the Mother of All Tax Shelters." The size of this break is so enormous that it dwarfs any that could be conceivably provided by a single state.

We, along with the entire AFL-CIO, support the cause of Puerto Rico workers seeking more jobs and better wages. It is obscene that astronomically high unemployment rate, and other mean levels of economic desperation are tolerated in any region, be it a state or a colony of the United States. As long as Puerto Rico is tied to the U.S., either as a territory or a state, residents on the mainland have, in our view, an enormous responsibility to see that the people of Puerto Rico enjoy to the fullest measure the fruits of U.S. citizenship.

In a January 14, 1993, San Juan Star editorial, Mr. A.W. Maldonado, a public relations consultant to Fomento, characterized Puerto Rico's non-relocation policy as "adopted for essentially public relations reasons" and "impossible to enforce." We agree. This is why the AFL-CIO has supported legislative action to amend Section 936 to allow the Treasury Department or the Courts to police the 936 companies.

All of these facts and figures don't begin to tell the real story. The real story here is told by Mitch Tucker and thousands like him who have been abandoned in this corporate migration to 936 tax shelters. In all too many cases, the tax code has allowed employers the added advantage of ridding themselves of older workers and replacing them with a workforce of 20-year olds. In the case of American Home Products, the average age of the workforce was 45. In the case of Acme Boot, the average age was 48. In our economy, factory workers at this age are almost unemployable. And the high cost of private health insurance is prohibitive.

In view of the generosity of the Administration proposal, we are concerned that Section 936 will continue to attract mainland businesses and, unfortunately, continue to finance the export of mainland plants and the destruction of mainland jobs. Clearly, such an outcome is not intended by this Administration, nor by anyone concerned about the use of public monies to destroy the jobs of the very taxpayers who are paying for this tax break.

For all of these reasons, our union, along with the entire AFL-CIO, continues to advocate the passage of law to prevent these substantial subsidies from causing mainland unemployment. At this time, two bills dealing with the issue of 936-inspired plant closures are before this Committee. I refer the members of this panel to H.R. 1210, introduced by Congressman Pete Stark of this Committee, and H.R. 1207, introduced by Representative Tim Roemer of Indiana and co-sponsored by Congressman Stark of this Committee.

H.R. 1210 and H.R. 1207 are substantially similar. Under these bills, a company must file a request with the Secretary of Treasury prior to commencing or substantially expanding operations in Puerto Rico. The Secretary will then make a determination if the operations will have a substantial adverse effect on employment at a related mainland enterprise. Notice of each request will be published in the Federal Register; the opportunity for public

comment will be provided and notice of the Secretary's determination shall also be published in the Federal Register. In addition, the background file relating to each determination shall also be made available to the public. The Secretary shall revoke the 936 credit of any corporation within three years of commencement or expansion if subsequent facts indicate that there has been a substantial adverse effect on mainland employment.

Where a company having a Section 936 affiliate issues notice under the WARN Act, H.R. 1207 goes farther by requiring the company to issue notice of its 936 status to the Treasury Secretary, as well as all other parties to the Act's notice procedure.

Because Section 936, even with the addition of the 65 percent wage credit, represents a continuing threat to mainland jobs, workers in towns like Clarksville, Tennessee, Elkhart, Indiana, and Brea and Palo Alto, California, are looking to Congress to stop the destruction of jobs and communities caused by the Possessions Tax Credit.

The members of this Committee and this Congress have the opportunity to perform a great service to workers by supporting the passage of H.R. 1210 or 1207 and by holding firm on the President's program to place a 65 percent cap on the Section 936 tax credit.

PHARMACEUTICAL PRODUCTION WORKERS
U.S. Mainland and Puerto Rico

Year	U.S. Excluding Puerto Rico	Puerto Rico	U.S. and Puerto Rico	Puerto Rico as % of U.S. Mainland	Puerto Rico as % of U.S. and Mainland
1980	88.7	7.5	96.2	8.5	7.8
1981	86.1	7.9	94.0	9.2	8.4
1982	84.1	8.0	92.1	9.5	8.7
1983	84.2	8.4	92.6	10.0	9.1
1984	81.8	8.6	90.4	10.5	9.5
1985	78.8	9.4	88.2	11.9	10.7
1986	78.4	10.3	88.7	13.1	11.6
1987	79.6	10.1	89.7	12.7	11.3
1988	81.0	10.5	91.5	13.0	11.5
1989	82.7	12.2	94.9	14.8	12.9
1990	81.3	13.3	94.6	16.4	14.1
1991	82.6	14.1	96.7	17.1	14.6
1992		14.9			

All data are in thousands

Sources:
For the U.S.: U.S. Department of Commerce, Bureau of the Census
For Puerto Rico: Puerto Rican Department of Labor

FOOTNOTES

(1) In 1991, OCAW brought a civil racketeering suit against AHP, alleging fraud in connection with the closure of an Indiana pharmaceutical plant and the opening of a similar facility in Puerto Rico. The suit alleged that AHP defrauded OCAW by falsifying applications for Puerto Rico local tax exemptions. Applicants are required to certify that their tax-exempted projects are not intended to have an adverse effect on mainland employment. The suit also named Puerto Rico officials for conspiring in this fraud. In 1992, a related action was filed on behalf of a class of over 1,000 former AHP workers in Indiana, New York, Pennsylvania and New Jersey who had been displaced under similar circumstances. On July 29, five days before trial in Federal Court, the parties agreed to a $24 million out-of-court settlement. The court action enabled OCAW to review discovery documents, including the firm's tax returns for the last ten years, and was useful to OCAW in gaining valuable insight on the practical application of Section 936.

(2) Impact of Internal Revenue Code Section 936 on Manufacturing Jobs in the U.S., Midwest Center for Labor Research, June 1991. It must be noted that these 25 cases cited in the MCLR study were assembled using trade press, company statements, and other easily acquired material. MCLR believes that a more in-depth investigation of business records and local press sources would significantly enlarge the list of Section 936 mainland-U.S. closures.

(3) In reviewing dozens of plant closings during the past decade, MCLR has developed a method for estimating the social costs associated with the loss of manufacturing jobs in the form of increased costs to the local, state and federal governments.

These social costs account for the decreased taxes that workers pay after they lose their jobs, and for the increased social welfare benefits that they receive, in the form of unemployment compensation, welfare and food stamps.

While it is not possible to arrive at precise estimates of social costs for the 25 cases in the study, MCLR has found that for each manufacturing job lost, the combined costs to all levels of government can range from $30,000 to $40,000 per worker in the first two years following a layoff or plant closing.

Mr. RANGEL. Thank you.
Mr. Tucker.

STATEMENT OF MITCHELL D. TUCKER, MEMBER, INTERNATIONAL EXECUTIVE BOARD, UNITED RUBBER, CORK, LINOLEUM & PLASTIC WORKERS OF AMERICA INTERNATIONAL UNION, AFL-CIO, AND PRESIDENT, LOCAL 330, CLARKSVILLE, TN

Mr. TUCKER. Mr. Chairman and members of the Ways and Means Committee, I want to thank you for allowing me to come here today to testify. My name is Mitchell Tucker. I am the president of Local 330, United Rubber Workers Union, based in Clarksville, TN. I also serve on the international executive board of our international union.

Let me begin by stating that the 100,000 members of my union strongly support President Clinton's proposal to scale back section 936 subsidies. Myself, along with my wife, Becky, my son, Doug, and 480 other workers at the Acme Boot Co., in Clarksville, TN, have devoted the better part of our working lives to producing Acme, Dingo, and Dan Post brand boots. Our company has had a long and proud tradition of producing a quality product that is uniquely American. Unfortunately, that tradition is coming to an end on May 21. Acme will close its doors.

The unfolding tragedy in Clarksville is a direct result of Government policy that has used our own tax money to finance the destruction of our factory and our jobs. In September, we were notified of the company's intentions to move to Puerto Rico. We were handed a document outlining the differences in labor costs. This document is attached to my testimony. We were told that if the company was going to reconsider, we would have to meet or beat the wage and benefit costs of operating in Puerto Rico.

Acme workers, who average $7.95 per hour, cannot meet, much less beat, the $4.50 hourly rate that Acme was going to pay in Puerto Rico, nor were we prepared to give up our small pension or medical coverage. In December, we learned that Acme had made a final decision. The company reported that it intended to employ 250 initially, and that employment could eventually reach 600 at Toa Alta. The company has readily admitted that there are Tax Code advantages to doing work in Puerto Rico.

Clearly, by any measure one chooses, the Clarksville plant is a runaway plant to Toa Alta. They have taken our equipment, our raw materials, our managers, our work, our jobs, and our future. There is no way that we will ever be convinced that section 936 was not directly responsible for the terrible hardship that we face in the years to come.

When financier William Farley took over Acme Boot in 1985, with the help of Michael Milken, Mr. Farley promised that there would always be work for the employees of Acme Boot if we worked hard to make Acme competitive. We have since agreed to work rule changes that resulted in a 35-percent increase in productivity, and we went 4 years without a wage increase. As a result, Acme Boot is a profitable company. Last year was the second best year in the history of Acme Boot. All of this has made no difference. The collapse of Mr. Farley's other junk bond companies undoubtedly led

to his decision to use section 936 as a prop under his crumbling empire.

In spite of our sacrifices and our willingness to be competitive, we have been undercut by our Government and betrayed by our employer. We are an older work force, with 362 people over 40 and an average age of 48. Three-fourths of the employees are women. Most of us have worked for 22 years and longer for this company. With Clarksville unemployment at 9 percent, our chances for finding work or any work is dismal.

For myself, my wife, and my son, Acme Boot was a way of life and our sole source of support. Because my wife suffers from breast cancer, we will not be able to afford the high cost of medical insurance. And my son and his wife have been unable to find work that provides insurance for them and their two children.

My personal story will be played out a hundred times over. We estimate that 85 percent of the people at Acme will have no access to affordable health insurance. Those able to retire with a full pension will receive $390 per month, after 30 years of service. Most will get but a small fraction of this.

We watched the President's State of the Union Message and were greatly heartened by his sympathy for workers who have been thrown into unemployment lines as a result of tax laws that encourage companies to export jobs. While the President's proposal is a strong and courageous step in the right direction, it will not be enough to prevent another Clarksville. We feel that it is unfair and even senseless to offer a single dollar of tax breaks, when economic growth in Puerto Rico comes at the expense of plant closures on the mainland. Certainly, such an outcome is not to be intended by this administration.

For these reasons, we encourage this committee and this Congress to consider two bills that have been introduced to deal with the continuing problem of runaway plants like Acme Boot. I specifically seek your support for H.R. 1210 and H.R. 1207, which have been cosponsored by Representative Stark of this committee and by Representative Tim Roemer of Indiana. If enacted, H.R. 1210 or H.R. 1207 would amend section 936 to prevent a runaway plant from enjoying section 936 tax benefits.

We urge Congress to hold firm on the President's proposal to scale back section 936 benefits, and we urge Congress to legislate an end to the taxpayer-financed destruction of jobs, so that we can ensure that other workers and communities do not go the way of Clarksville.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

STATEMENT BY MITCHELL D. TUCKER, PRESIDENT UNITED RUBBER, CORK, LINOLEUM & PLASTIC WORKERS OF AMERICA INTERNATIONAL UNION BEFORE THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES CONCERNING SECTION 936 OF THE INTERNAL REVENUE CODE APRIL 1, 1993

My name is Mitchell Tucker, and I am the President of United Rubber Workers Union Local 330, based in Clarksville, Tennessee. I also serve on the International Executive Board of the United Rubber Workers International Union (URW), which is a labor union affiliated with the AFL-CIO. The URW represents 100,000 workers in the United States and Canada.

I appreciate the opportunity to testify on the Administration's proposals to amend Section 936 of the federal tax code.

For the past 36 years, I have been employed by the Acme Boot Company in Clarksville, Tennessee, in positions such as machine operator and mechanic. My wife Becky was also employed at Acme and has worked there for the past 23 years. My son Doug was an employee of Acme Boot for eight years.

My wife, my son and I, along with 480 other workers in Clarksville, have devoted the better part of our working lives to producing Acme, Dingo, and Dan Post brand boots. Our company has had a long and proud tradition of producing a quality product that is uniquely American. Unfortunately, that tradition is coming to an end. On May 21, Acme will close its doors, forcing 480 hard-working citizens of Tennessee to participate in a much different American tradition: standing in the unemployment line.

Bitterness cannot begin to describe the way we feel about being turned out after so many years. We at Acme Boot, are an older workforce with 362 people over 40 and an average age of 48. Most of us have worked for 22 years, and longer for this company. Three-fourths of the employees are women, and 15 percent are African-American. Even under the best of circumstances, the future for this older, mostly female workforce is bleak. With Clarksville unemployment at 9 percent, our chances for finding work--any work--are almost non-existent.

Bitterness can sometimes be overcome when one accepts that we are all, at one time or another, beset by adversities that are beyond our control. The unfolding tragedy at Clarksville, however, is not an act of God, but is the direct result of the policies of our own government that has, in fact, used our own tax money to finance the destruction of our factory and our jobs. For this reason, our bitterness will not diminish, nor can it be swallowed.

In November of last year, we were approached by representatives of the Tennessee Industrial Renewal Network and the Midwest Center for Labor Research. Both of these groups are non-profit organizations that offer assistance to workers who are facing plant closings or layoffs. From them we learned that Section 936 was designed to encourage companies to invest and create jobs in U.S. territories like Puerto Rico. We learned that tax breaks of close to $3 billion each year were given to mainland companies to set up business in Puerto Rico. And, we learned that many companies like Acme Boot had closed factories in order to operate tax-free under Section 936.

We learned that Section 936 tax breaks were really meaningless until Puerto Rico granted an exemption from local taxes. We found that local tax exemptions, as well as Labor Department training funds, could not be lawfully granted to a runaway company that intended to destroy jobs on the mainland. When we asked local officials at the Tax Incentives Office and at the Right To Work

Administration to provide information on Acme's applications for tax incentives and U.S. Department of Labor training grant funds, we were completely stonewalled. While the authority to prevent the relocation of jobs from the mainland under Section 936, as well as the Job Training Partnership Act, actually lies with local officials in Puerto Rico, we found that these authorities had no interest in upholding the law.

Until our story hit the newspapers, Acme made no secret of their intentions to relocate our factory to Puerto Rico. In September, the company indicated that they were close to making a final decision on closing the Clarksville plant. Acme Boot President Mike Vogel said that they were planning to start boot-making operations in Puerto Rico. We were told that if the company was going to reconsider the closing at Clarksville, we would have to meet or beat the wage and benefit costs of operating in Puerto Rico. At that point, he handed us a table outlining the differences in labor costs. (I have attached this document to my testimony). Mr. Vogel then urged us to decide quickly as he had arranged to return to Puerto Rico in two weeks to make a decision on the purchase of property.

After a very emotional meeting, the workers decided that they could not meet, much less beat, the $4.50 hourly rate that Acme was prepared to pay its Puerto Rico employees. Nor were we prepared to give up our small pension or our medical coverage.

On October 16, we were notified that the plant would definitely close, and, on November 5, 215 employees received WARN notice. On December 10, Caribbean Business reported that Acme had made final arrangements to open manufacturing at a site in Toa Alta. The company reported that it intended to employ 250 initially and that employment could eventually reach 600. Subsequently, we were informed by sources in Puerto Rico that supervisory employees were in training on the mainland during the week of January 4, and that hourly people would be hired during the week of January 11.

In a December 26 interview with The Clarksville Leaf Chronicle, Mr. Vogel readily admitted that there were tax code advantages to doing work in Puerto Rico. Subsequently, on January 9, 1993, Acme Boot issued public notice in Puerto Rico that it was seeking an industrial tax exemption for its manufacturing operation in Toa Alta. These local exemptions reduce Puerto Rico taxes on income from 36 percent to a range of two to six percent. This local exemption is the first and most important step to obtaining Section 936 tax benefits.

On February 15, the remaining manufacturing employees at Clarksville received WARN notice of a May 21 final closure date.

Beginning in September 1992, members of my union have been ordered to crate and ship dozens of boot-making machines from the plant loading dock in Clarksville marked for the Acme Footwear Company, Inc. plant in Toa Alta, including United Inseam Sidelaster machines, Staple Dutchman machines, lay rib machines, exhaust fans, sole racks, insole tackers, Jupiter Stitchers, pin racks, flat racks, dies, lasts, tote boxes, shank pots, cement machines, toe laster tooling, spray guns, lasting irons, bin storage racks, office furniture, last bins, factory furniture, cutting machines and a shank reducer. Many other machines are being prepared for shipping or are being ordered as leased substitutes for machinery needed in Clarksville until the shutdown. We have also shipped large amounts of our raw material inventory including leather, soles, heels, thread and cement.

In addition, we have identified three Clarksville managers who have taken key management positions in Toa Alta. We also know that Acme Footwear has obtained a condominium residence for the purpose of housing these runaway managers.

Since our story has appeared in the media, Acme managers have attempted to deflect criticism by suggesting that the Toa Alta facility is somehow "different" than Clarksville. In particular, Acme is claiming that "boot uppers" made at Clarksville will be outsourced and shipped to Toa Alta where they will be "bottomed." This is nothing new for the Acme Boot Company. Our members have been putting imported boot uppers on bottoms in Clarksville since 1971.

Clearly, by any measure one chooses, the Clarksville plant is a runaway to Toa Alta. They have taken our equipment, our raw materials, our managers, our work, our jobs and our future. There is no way that my family, or the hundreds of other families at Acme Boot will ever be convinced that Section 936 was not directly responsible for the terrible hardships that we face in the years to come.

The plant, which was built in 1965, is a modern, 200,000 square foot state-of-the art facility. Acme Boot is a profitable company; last year was the second best year in the company's history. In part, the company's success is due to our willingness to accept concessions to remain competitive. We agreed to work rule changes that resulted in a 35 percent increase in productivity. And we went four years, from 1986 to 1990, without a wage increase. Our wages, which average $7.95 per hour would make most American manufacturers green with envy.

When financier William Farley took over Acme Boot in 1985 with the help of Michael Milken, Mr. Farley came to Clarksville and told us that this would be a place where we, our children and our grandchildren could work. In return for our hard work and dedication, he promised that there would always be work for the employees of Acme Boot. During his brief run for President in 1987, Farley campaigned on the platform of rebuilding our industrial base and on retaining American jobs.

Since 1987 all of this has changed. The collapse of his other junk bond-financed businesses has undoubtedly caused him to lean heavily on the profitable Acme Boot business for support. And, his exploitation of Section 936, and the American taxpayer was just a handy and convenient way to put one more prop under his crumbling empire.

The facts are simple. In spite of our efforts, our sacrifice and our willingness to be competitive, we have been undercut by our government and betrayed by our employer. We've been used up and left on the scrap heap like an old tire. We resent it, and find it obscene that the destruction of our way of life has been financed by the taxes we've paid on what little we've earned.

For myself, my wife and my son, Acme Boot was a way of life, and our sole source of support. Although I will be able to extend my employment past May 21 by transferring into the Shipping Department, my future is uncertain once the plant closes. My wife and son have already been terminated, Between them they received a total of $1,600 in severance benefits. I'm 53 years old, and while I will be eligible for early retirement at 55, my monthly pension check will come to only $234.00. My wife will be eligible for early retirement in 5 years and will receive a monthly check for $149.00. An eventual monthly benefit of $383.00 is all the three of us will have to show after giving a total of 67 years to this company.

Because my wife suffers from breast cancer, we will not be able to afford the high cost of medical insurance. My son and his wife have been unable to find work that provides insurance, so when their coverage with Acme Boot runs out five weeks from now, they along with their two children, will be without insurance.

As entire families, indeed entire generations of people in Clarksville, were encouraged to work for Acme Boot, my personal story will be played out a hundred times over. We estimate that 85 percent of the people at Acme Boot will not have access to spousal health insurance after they lose their Acme Boot coverage. Those lucky enough to retire with a full pension will receive $390.00 per month after 30 years of service. Most, will get but a small fraction of this.

For all of these reasons, the workers at Acme Boot along with their union, strongly support President Clinton's proposal to scale back Section 936 tax subsidies.

We watched the President's State of the Union message, and were greatly heartened by his sympathy for workers who have been thrown into unemployment lines as a result of tax laws that encourage companies to export jobs. His characterization of Section 936 was right on the mark:

> "...the tax code should not express a preference to American companies for moving somewhere else, and it does in particular cases today."

The President's program limits the value of this tax break to 65 percent of wages paid in Puerto Rico. While this proposal is a strong and courageous step in the right direction, it will not be enough to prevent another Clarksville. The Treasury Department reports that this subsidy is probably far too generous to have any impact on Acme Boot's decision to relocate. Nevertheless, we are not prepared to question the Administration's generosity. I have personally met with a number of union representatives from Puerto Rico, and, like the President, appreciate the special needs of workers in Puerto Rico for jobs and a decent standard of living.

But, it is unfair and even senseless to offer a single dollar of tax breaks when employment in Puerto Rico comes at the expense of unemployment on the mainland. The 65 percent wage credit will have no impact on major 936 employers in Puerto Rico in the footwear, apparel, food, plastics and rubber industries. For companies like Acme Boot, the tax incentives to export jobs to Puerto Rico will remain unchanged.

Certainly, such an outcome is not intended by this Administration. Nor would it serve anyone's purpose for other groups of dislocated workers like those in Clarksville or Elkhart to continually reappear before this Committee.

For these reasons, we encourage this Committee and this Congress to consider several bills that have been introduced to deal with the continuing problem of runaway plants like Acme Boot. I specifically seek your support for House bills 1210 and 1207 which have been co-sponsored by Representative Stark of this Committee and by Representative Tim Roemer of Indiana. If enacted, H.R. 1210 or H.R. 1207 would amend Section 936 to allow the Secretary of Treasury to withhold or revoke Section 936 tax benefits on any income earned by a runaway plant.

While such legislation may come too late to save the 480 jobs at Acme Boot, it would be a consolation to know that our tragedy stood for more than the enrichment of William Farley. We urge Congress to hold firm on the President's proposal to scale back Section 936 benefits. And, we urge Congress to legislate an end to the taxpayer-financed destruction of jobs so that we can insure that other workers and communities do not go the way of Clarksville.

ACME BOOT COMPANY
HOURLY COST COMPARISON
(BASED ON HOURS WORKED)

[illegible]

	CLARKSVILLE	PUERTO RICO	DIFF.
Wages (1)	$ 8.15	$ 4.50	+$ 3.65
Vacations	.45	.18	+ .27
Holidays	.22	.25	- .03
Seniority Pay	.18	—	+ .18
Christmas Bonus	.15	.10	+ .05
Pay Benefits	1.00	.53	+ .47
Total Pay	$ 9.15	$ 5.03	+$ 4.12
Social Security	$ .70	$ .38	+$ .32
Unemployment	.44	.14	+ .30
Pension	.49	--	+ .49
Group	1.03	.26	+ .77
Workman's Comp.	.39	.18	+ .21
Non-Pay Benefits	$ 3.05	$ .96	+$ 2.09
Total Compensation	$ 12.20	$ 5.99	+$ 6.21

(1) Includes Base Pay, O/T Premium, Improshare

ACME BOOT COMPANY
HOURLY COST COMPARISON
(BASED ON HOURS WORKED)

	CLARKSVILLE	PUERTO RICO
Vacations	6%	4%
Holidays	7 days	10 days
Seniority Pay	$ 350	--
Christmas Bonus	2%	—
Social Security	7.65%	7.65%
Unemployment	$ 856	$ 272
Pension	$ 950	—
Group	$2,000	$ 500
Workman's Comp.	$ 750	$ 3.55/100

CARIBBEAN BUSINESS

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Runaway plant panic

Are labor unions the biggest threat to 936?

By BEATRIZ DE LA TORRE
CARIBBEAN BUSINESS
Special Correspondent

CB EXCLUSIVE

Buried under a growing stack of complaints from stateside labor unions, the Fomento Tax Exemption Office has seen the number of corporations wanting to do business in Puerto Rico dramatically shrink.

"The walls are tumbling down around us," said Charles Jimenez Nettleship, acting director of the tax office. "Since Washington pushed the 936 panic button, we've had only seven requests for tax exemptions."

(Continued on page 2)

FRONT PAGE STORY

Normally, he said, the Fomento tax office handles some 20 new requests each month from U.S. companies wanting to start operations on the island.

"The runaway challenges are the latest trend," said Jimenez. "What we are seeing is totally abnormal. So far this year, we've received four challenges. Whereas in the 10 preceding years, we had seen only one complaint, the American Home Products case."

So far, three international unions — the Oil, Chemical and Atomic Workers (OCAW), United Rubber Workers (URW) and the United Auto Workers (UAW) — have vowed to battle companies that lay off workers on the mainland to move to the island.

One, the United Auto Workers union, has already asked the Rossello Administration to revoke the tax exemption granted to an aerospace company, Sundstrand Corp.

Another, the Oil, Chemical and Atomic Workers Union which, in the summer of 1992, won a $24 million settlement against American Home Products, has asked for the tax exemption records of Colgate-Palmolive and Mennen.

Richard Leonard, who heads the union's special projects office, said OCAW soon will also go after the records of Syntex Corp., which announced last month that it was going to transfer its Palo Alto, Calif. pharmaceutical production to Puerto Rico.

Earlier, the United Rubber Workers Union requested the documents filed by Acme Boot, a U.S. manufacturer that allegedly closed a unionized Tennessee plant to move to Puerto Rico. The relocation recently earned Acme the top spot in the third annual "Plant Closing Dirty Dozen" picked by the Chicago-based Federation for Industrial Renewal. The group, concerned with economic dislocation, said in a Washington news conference that the chosen companies were the worst examples of "irresponsible plant closings and community abandonment."

In June 1991, the Midwest Center for Labor Research released a nationwide study identifying 25 mainland plants where 7,306 direct jobs had been lost to the island. The labor think-tank estimated the ripple effect being an additional 21,900 lost jobs in the United States.

Since then, the runaway controversy has sparked national media coverage and caught Capitol Hill's attention.

The unions' fierce anti-936 stance is apparently making corporate America think twice before moving to Puerto Rico.

The last big batch of tax grant approvals apparently took place in December 1992 — the last month of the Hernandez Colon administration and before President Clinton moved into the White House.

A record 53 tax exemptions grants were signed that month, said Jimenez.

"We were under a lot of pressure to get out pending cases before Dec. 31," said Jimenez, who has worked nine years for the Fomento tax office.

> ***"What we are seeing is totally abnormal. So far this year, we've received four challenges. Whereas in the 10 preceding years, we had seen only one complaint, the American Home Products case."***
>
> **— Charles Jimenez Nettleship**

Meanwhile, the Sundstrand grant, signed on Dec. 31, 1992, by ex-Gov. Rafael Hernandez Colon, has come back to haunt the Commonwealth government with more accusations of luring U.S. companies to the island at the expense of mainland workers.

The controversies brewing around the 936 companies are also forcing the Fomento tax experts to rewrite their internal regulations to handle the touchy issue of runaways.

"We are in the process of revising our regulations," said Jimenez, explaining that the revisions are taking place as his staff gets ready for an unprecedented administrative hearing — one that he fears will be the first of many.

On March 18, the Fomento tax office will listen to a formal request from the United Auto Workers (UAW) union, which is asking Gov. Pedro Rossello to revoke the Section 936 benefits granted two months earlier to Sundstrand, a Rockford, Ill. aerospace company with worldwide operations.

UAW, which represents some 200 workers at a Sundstrand plant in Brea, Calif., is one of the three international unions separately asking the Commonwealth government to open its tax exemption records for their inspection.

The next day, the tax office will hear the Acme workers' case, a labor spokesman said.

"It will be a small trial," said Jimenez, who warned that "if the number of these hearings increases we are going to need a larger staff to handle this situation."

With 32 employees, many of them clerical, the tax exemption office annually handles between 800 and 875 cases. Although most of the workload is amending existing tax breaks, it also includes reviewing new grants and revoking troublesome ones. Last year, for example, the office struck 105 cases from its books.

At stake in the hearings, however, is an issue far more crucial than the fate of a single company: how will the Puerto Rico government answer future charges from organized labor that the island is taking away jobs from U.S. mainland communities by giving corporations a set of unique tax breaks and other incentives?

Until now, Jimenez has denied all requests for public records.

"I've refused to release those documents because they are not public documents," he said. "I've got a 1981 opinion from the secretary of justice that clearly establishes that those records are confidential. They contain private information, such as manufacturing processes that are protected under patents, financial statements and marketing strategies."

"All that's confidential."

"That they (the unions) may sue me? That's their right. But I have to obey the law."

Nonetheless, Jimenez, who said the only public document in the files are the public notices published in the local press, is apparently troubled by the runaway issue.

"We are aware that a runaway shop is an illicit prac-

936 continued on page 14
See related editorial on page 56

FRONT PAGE STORY

continued from page 2

tice under the federal laws," he said

However, he added, the issue is far more complex than it may seem at first glance

To begin with, he explained, the Commonwealth "negotiates in good faith" the tax exemptions, accepting at face value the information provided by the companies that their new facilities are not going to cost existing jobs.

Yet even after a challenge is raised, he added, Puerto Rico has to weigh the allegations that a plant is a runaway against the real economic impact on the mainland and the possibility that the company would have gone elsewhere anyhow

"We are talking to the various government agencies — Labor, Fomento, Hacienda, everybody — to determine what will be considered 'substantial damage' to employment in other states," he said. "This is a first, because we had never considered the issue as such before"

For UAW attorneys, who have charged that Sundstrand is transferring all jobs from Brea, Calif., and some from Phoenix, Ariz. to Puerto Rico and Lima, Ohio, the question is more clear-cut.

"The vast majority of the jobs are going to Puerto Rico," said David Adelstein, a California attorney working for UAW. "Sundstrand has admitted its moving the jobs to Puerto Rico. They are not denying that it's going to have an adverse impact here What they are saying is that they would have moved out of Brea anyhow, which we doubt"

"Their defense is that if they didn't go to Puerto Rico, they were going to move overseas," Adelstein said. "Puerto Rico officials weren't even aware of Sundstrand's operations until the union questioned the company's tax breaks"

"The problem is that until I brought this matter to the attention of Puerto Rico officials, Sundstrand had not made an express application for a tax exemption grant," he explained.

Instead, he added, Sundstrand was benefiting from a Westinghouse grant.

Sundstrand, which bought Westinghouse's electrical systems division in early 1992, denies that the California shutdown is a response to moving to Santa Isabel.

"We made a decision some time ago to close the Brea plant based on the expense and efficiency of the plant," said Sundstrand spokesman Brad Considine. "Puerto Rico surfaced much later, when we bought the Westinghouse electrical systems division. For someone to make a direct correlation between the two is not accurate"

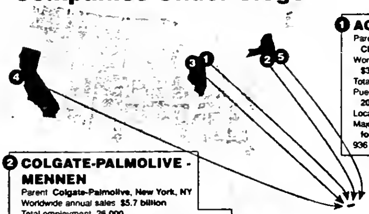
Santa Isabel, according to Considine, was one of two plants acquired from Westinghouse The other is in Lima, Ohio Considine said he was uncertain of how much of the old Westinghouse production will be retained and how much corresponds to the Brea production lines.

Meanwhile, the next 936 battleground apparently may be found near San Francisco, at the last Syntex Corp. plant in the United States

On Feb. 8, Syntex announced in California it would eventually "shift all drug production for the U.S. market to its facility in Puerto Rico," according to the San Francisco Chronicle newspaper.

The Panama-based pharmaceutical manufacturer, which has been a 936 company since 1975, told the U.S. media that the decision was part of a worldwide

Companies Under Siege



1 ACME BOOTS
Parent **Farley Industries Chicago, Ill.**
Worldwide annual sales **$3 billion**
Total employment **60,000**
Puerto Rico employment **200 to 250 (projected)**
Location **Toa Alta**
Major PR products **footwear**
936 tax savings **n/a**

2 COLGATE-PALMOLIVE - MENNEN
Parent **Colgate-Palmolive, New York, NY**
Worldwide annual sales **$5.7 billion**
Total employment **26,000**
Puerto Rico employment **89 (excluding Mennen)**
Location **Guayama, Juncos**
Major PR products **liquid detergents, toothpaste, deodorants**
936 tax savings **n/a**

3 SUNDSTRAND
Parent **Sundstrand Corp., Rockford, Ill.**
Worldwide annual sales **$1.6 billion**
Total employment **12,000**
Puerto Rico employment **175**
Location **Santa Isabel**
Major PR products **electrical generators for aircraft**
936 tax savings 1980-90 **n/a**

4 SYNTEX
Parent **Syntex Corp. Palo Alto, California**
Worldwide annual sales **$2.1 billion**
Total employment **11,000**
Puerto Rico employment **333**
Location **Humacao**
Major PR products **Naprosyn, oral contraceptives**
936 tax savings 1980-90 **$0 (US net operating loss exceeded 936 benefits)**

5 WHITEHALL LABORATORIES
Parent **American Home Products, New York, NY***
Worldwide annual sales **$6.9 billion**
Total employment **47,800**
Puerto Rico employment **1,400**
Location **Guayama**
Major PR products **Premarin, Anacin, Advil**
936 tax savings 1980-90 **$450 million**

*AHP without admitting it was a runaway, reached a $24 million out-of-court settlement with OCAW in 1982

Sources: Companies, Tax Exemption Office, 1992 GAO Report, Caribbean Business Book of Lists and Fortune Magazine

cost-cutting effort.

As a result of the move, the newspaper reported, 280 Palo Alto workers are scheduled to lose their jobs, although the company has offered to relocate some of its workforce

The shutdown decision is the second major move by Syntex, which announced in November 1992 that it was restructuring its entire operation to respond to changes in the health-care market. Syntex, which employed 11,500 people, already slashed 1,000 jobs in November.

Before then, however, the company had publicly said it was planning to expand its Palo Alto plant by moving into a new 145-acre site near San Jose, Calif., to be shared with its diagnostic subsidiary, Syva Co.

At Palo Alto, Syntex spokeswoman Linda Thomas confirmed that some of the drugs currently being made in California will be transferred to Puerto Rico. "We are closing Palo Alto over the next two years and the products will be moved to other sites, including Puerto Rico," Thomas said.

When asked what other sites and which products are being considered, Thomas replied: "We haven't decided yet"

Moreover, the move may not be as easy as it may have seemed before

"We are considering asking for the Syntex tax exemption records," said OCAW's Leonard, who spearheaded the two-year legal fight against American Home Products.

Although none of the Syntex workers are unionized, OCAW may wage the runaway battle for them — as an act of self-defense. During the past 10 years, the Denver-based 100,000-member union has seen its ranks shrink by 40% as many pharmaceutical firms relocated to Puerto Rico and overseas in search of lower taxes and cheaper labor. In Puerto Rico, no pharmaceutical plant is unionized.

Also, with the long-lasting economic slump showing no signs of really abating, the Puerto Rico-based companies may increasingly find themselves in a defensive position.

"There is a growing anti-runaway grass roots movement here in the States," said Leonard. "For example, it was a grass roots movement that clued us on the Acme Boot case.

"They called us and told us that they had heard rumors that Acme may be going to Puerto Rico, so we started watching for it. Two months later, Fomento was boasting about Acme and we started to work." ■

Chicago Tribune

35¢ Monday, February 1, 1993. Final

Union wants Puerto Rico to boot Acme

By Stephen Franklin

Acme Boot Co. was there when Mitch Tucker was born, when he needed a job 36 years ago, and it would always be there, he figured, for the children of the plant's 33 families.

Seven dollars and ninety-five cents an hour is not much of a union wage nowadays for factory work, even in Clarksville, Tenn., he concedes.

Still, making Western-style and fashion boots at Acme, the town's second-biggest employer, meant security to him and his wife, Becky, and nearly 800 other workers, most of them middle-age women.

That security now seems a lost dream since the plant is fated for a June closing. But Tucker, president of United Rubber Workers Local 330, his union and activists from other unions are not surrendering so easily.

Their immediate target is Chicago-based Farley Industries Inc., a privately held company led by industrialist William F. Farley, which plans to end production at the 63-year-old plant in June.

As Acme lays off the plant's remaining 500 production workers, it will open another one with about 250 workers in Puerto Rico, where, because of U.S. and Commonwealth of Puerto Rico laws, it will pay a small fraction of corporate taxes.

The unions' strategy is to block the company from taking advantage of Puerto Rico's tax breaks. They are relying on a 1987 commonwealth law that says local officials can refuse to waive the local corporate taxes if they find that the company's move caused economic hardships on the mainland.

Yet this is more than a one-time showdown in Clarksville.

It is part of a small but growing effort by unions to end government policies and programs that they say help companies make job transfers to Puerto Rico and other low-wage locations.

Still, companies such as Acme, with low-skill and labor-intensive jobs, increasingly argue that the only way for them to survive is to go to Puerto Rico, Mexico, Latin America, the Pacific Rim and other low-wage locations.

And as job flight becomes a flood, these companies say it is more difficult for them to compete. At least 80 percent of the footwear products sold by their U.S. competitors come from overseas, Acme officials say.

So far, labor has been losing this often rancorous battle.

"Nobody has been successful. How do you stop them?" asked Herman Starobin, research director for the International Ladies Garment Workers Union. His union has seen 300,000 jobs in the U.S. apparel industry disappear in the last 15 years, many of them going overseas.

Photo for the Tribune by Christopher Berkey/AP

Mitch Tucker, president of United Rubber Workers Local 330, hopes to block Acme Boot's move from Tennessee to Puerto Rico.

Organized labor has, however, had some victories.

Just before a trial began last July in San Juan, Puerto Rico, American Home Products Corp. agreed to pay $24 million to settle the Oil, Chemical and Atomic Workers International Union's charges that the company had illegally sent work from Elkhart, Ind., to Puerto Rico.

The unions hope for a similar victory against Acme.

In this case, the unions are again pointing to Section 936 of the U.S. Internal Revenue Code, which, they say, creates "runaway shops" by waiving federal corporate taxes on profits earned in U.S. territories such as Puerto Rico, Guam and the Virgin Islands.

"It's a case of tax loophole-driven job destruction," says Greg LeRoy, an official with the Chicago-based Midwest Center for Labor Research, a labor-supported research organization.

Acme officials acknowledge that they look forward to the tax breaks, but add that they are not breaking laws.

To be sure, federal law does not bar U.S. companies from benefiting from the 100 percent tax break if they move jobs from the mainland. And as Acme officials see it, they are not in violation of Puerto Rico's 1987 law, since the company is not shifting the same work from Tennessee.

Rather than building boots from scratch, as the company did in Clarksville, they say the new plant will be a finishing operation for uppers and half boots.

"If we did or did not go to Puerto Rico, we would close Clarksville," said Acme's president, Mike Vogel. The company decided some time ago that it would cut back on its own manufacturing and buy more from other U.S., as well as Mexican and Brazilian, companies, he said.

This dispute over job flight is no small matter in Puerto Rico.

About 115,000 workers are employed there by 300 mainland companies, which take advantage of the federal and island tax provisions, says Peter Holmes of the Puerto Rico U.S.A. Foundation in Washington.

These mainland firms indirectly create another 200,000 jobs, and that adds up to about one-third of Puerto Rico's work force, according to Holmes, whose group is made up of 70 major U.S. corporations.

"Virtually all of the firms are in Puerto Rico for two reasons," he said. "Either they are developing new products, or they found they could no longer compete and had to move offshore."

Pointing out that mainland companies in Puerto Rico reap about $2.7 billion yearly in federal tax benefits, U.S. Rep. Fortney H. "Pete" Stark (D-Calif.) tried unsuccessfully last year to pass a bill requiring the Treasury to confirm that the job transfers do not harm mainland workers.

The ACME dispute is not the only issue likely to face Puerto Rico's officials, who, according to unions, have never refused a company a tax break on the grounds that its relocation would hurt mainland workers.

Sunstrand Corp. of Rockford has stirred a similar complaint of using federal benefits to shift work from a plant in Brea, Calif., to Puerto Rico.

The company disputes the claim that it is shifting the 225 jobs now done by members of the United Auto Workers.

Brad Considine, a Sunstrand official, said the company decided to close the California plant before it bought the one in Puerto Rico from Westinghouse Electrical Systems Inc. "Puerto Rico came up as an alternative as an innocent result of our acquisition," he said.

But the unions' complaint goes beyond shifting jobs to Puerto Rico.

Since Farley Industries took over Acme in 1985, they say Acme has taken a low-wage strategy, which has led to its closing of three other plants in Tennessee for a total of 640 jobs.

Vogel sees it differently. "The last five or six years have been very tough," he said. "What we are trying to do is make this company well so we have jobs for the remaining employees."

In the last year his company also has tripled production and doubled its non-union work force in El Paso, where it has about 700 workers, Vogel said. He would not indicate what the El Paso workers receive.

As for the Clarksville workers, Vogel says the company will be a "good corporate citizen" and provide more assistance on the closing than required by law. The facility will stay open as an office and distribution center with about 250 employees, he says.

The first stage of its shutdown will begin Jan. 29 when Acme lets go 211 workers, according to the union.

Mitch Tucker hopes he will not have to take advantage of the company's charity come June. But he also has doubts about whether the workers can stymie the move and block Acme from receiving Puerto Rico's tax benefits.

"It's not so clear we are going to win," he says, "but we'll do everything we can."

The San Juan Star

Virgin Islands 80¢ Tuesday, January 12, 1993 Puerto Rico 30¢

Rosselló urged to deny factory tax benefits

Tennessee union: Acme Footwear is runaway plant

By ROBERT FRIEDMAN
Scripps Howard News Service

WASHINGTON — Gov. Rosselló has been asked to deny tax benefits to a Tennessee factory that plans to relocate in Puerto Rico on grounds that it is a "runaway plant."

In a letter dated Jan. 9, the president of the union local representing the factory's employees asserted that the Acme Footwear plant, set to begin operations this year in Toa Alta, will be carrying out essentially the same manufacturing procedures as is now done in its Clarksville, Tenn., plant.

"We state to you unequivocally that this is a runaway shop," wrote Mitchell Tucker, president of the United Rubbers Workers Local 330.

" . . . If an exemption has already been granted, you must revoke it . . . if an application is now pending, it should be denied," said Tucker.

Neither the governor nor other Commonwealth officials could be reached Monday for comment. But newly installed Fomento Administrator Clifford Myatt had said last week that Acme had not yet received a tax exemption and that the case would be investigated.

Puerto Rico law prohibits giving tax benefits to manufacturing companies whose relocation on the island is directly responsible for job losses in the states.

Acme Boot Company, Inc., the parent company of Acme Footwear, has applied for benefits that would greatly reduce its local taxes to about 5 percent, under the Puerto Rico Tax Incentive Act of 1987. The company also will try to obtain Section 936 benefits, allowing it to repatriate profits without paying federal taxes.

Acme has said it is closing its Clarksville plant in June and moving to Puerto Rico as part of an overall company policy to scale down its manufacturing. While the Clarksville factory made the whole boot, the Puerto Rico plant would only do bottom finishing work on boots, according to personnel manager Terry Ray.

But Tucker wrote in his letter to Rosselló that Acme "plans to perform Clarksville production processes on Clarksville brand name boots with equipment shipped from Clarksville."

The letter continued: "We believe that any attempt by Acme Footwear, Inc., to represent the facts otherwise, especially on its application under the Puerto Rico Tax Incentive Act, would be fraudulent."

The president of the local, which represents 600 workers, and 300 others who have recently been laid off at the Clarksville plant, said "time is of the essence" because the company plans to lay off 211 more union members by the end of the month.

A copy of the letter was sent to Resident Commissioner Carlos Romero Barceló, who also could not be reached Monday for comment.

The rubber workers union also sent a letter to Vice Presient-elect Albert Gore, a former senator from Tennessee.

"The situation at Acme Boot will be your first opportunity to make a difference and stop taxpayer-financed job destruction," the letter said.

Mr. RANGEL. Thank you.
Mr. Johnson.

STATEMENT OF PETER B. JOHNSON, EXECUTIVE DIRECTOR, CARIBBEAN/LATIN AMERICAN ACTION

Mr. JOHNSON. Mr. Chairman, thank you for the invitation to testify. My written testimony is submitted for the record.

I would like to make a few additional comments for the record, and argue that the administration proposal runs at cross-purposes to U.S. interests in the Caribbean Basin.

As Mr. Pickle very clearly reminded us, the origins of the Caribbean Basin logic for maintenance of the 936 program goes back to 1986 and 1987.

Mr. PICKLE. It actually goes way back further than that, back to the Philippine Islands, but it does go back a few years.

Mr. JOHNSON. I don't go back that far, Mr. Pickle.

It is also worthy of note and repeating, Mr. Pickle's point, that he argued strongly in 1989 to assure that there was a $100 million target for these funds, if in fact the program was going to be successful.

It is important to note today in 1993 that the figures accumulated in a study that we did show that there is nearly $700 million accumulated loans in the Caribbean Basin as a consequence of this program. More important, at the end of this year, if the program continues in the direction that it is going, these small countries in the Caribbean Basin will be the beneficiaries of about $1.5 billion in these kinds of loans.

I think it is also important, Mr. Chairman, to note that the small island of Grenada, in 1986 and 1987, was very important to the considerations of this committee and the administration in maintaining the 936 program. The island of Grenada, as we all remember, was just coming out of many years of Marxism and bad economics and worse politics. It was the 936 program, through four companies, in particular, as I recall, Johnson & Johnson, Schering, Plough, Abbott Laboratories and Smith Kline Beecham that went into that island and jump-started the economy with jobs and with investments, and the history from that point forward is clear and on the record.

I would like to suggest particularly to Mr. Rangel, who knows much more about this than I do, that perhaps it is time to take a look at Haiti with respect to 936 funds, as we did in 1986 with respect to Grenada. My understanding is that the administration is seeking to aggregate substantial funding to try to get that economy going, once the politics are straight. Wouldn't it be creative if we could find a way to direct some 936 funds into promoting investment back into the beleaguered island of Haiti, at a time when jobs created by the private sector are going to be inevitably the answer to Haiti?

Moreover, I could not help noticing, I think Sunday in the Washington Post, the front-page story about increasing drug trafficking coming through the Caribbean Basin countries now that U.S. assistance programs have diminished.

I think it is important to understand that the tax information exchange agreements, which are in place as a condition to receiving

936 funds, have in fact been an important tool to solving some of these problems. It would seem to me to be a pity and a shame that the very condition that we put in place to deal with this problem may be weakened if 936 funds for the program were unavailable.

Since Ambassador Bernal and others have already made the additional arguments, I only wanted to reemphasize to you this point about Haiti. I think it is important and I think the administration would find it very useful, and it may well be a solution to a very sticky problem.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF PETER B. JOHNSON
EXECUTIVE DIRECTOR, CARIBBEAN/ LATIN AMERICAN ACTION

PRESENTED BEFORE THE HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

ON PRESIDENT CLINTON'S PROPOSAL FOR
PUBLIC INVESTMENT AND DEFICIT REDUCTION

APRIL 1, 1993

I. INTRODUCTION

Mr. Chairman and distinguished Members of the House Ways and Means Committee, I would like to thank you for the opportunity to appear before you today and to present the views of Caribbean/Latin American Action on the Administration's proposal for public investment and deficit reduction. Specifically, my comments will concentrate on the proposal to reduce Section 936 tax incentives. Caribbean/Latin American Action is a non-profit 501(c)(3) organization committed to promoting private-sector generated economic development in the countries of the Caribbean Basin.

Clearly, the countries of the Caribbean Basin are deeply concerned over the future of Section 936. A reduction in Section 936 tax benefits substituted for wage credits would jeopardize the pool of 936 funds available for development-oriented private sector projects in the Caribbean Basin.

Recent studies conclude that Section 936 funds have become one of the leading sources of project funding for new investments and business growth in eligible Caribbean Basin countries. In some countries, 936 funds are the primary source of loan financing. 936 funds are vital to the development goals of the Caribbean Basin, particularly as other sources of development assistance have declined.

In my testimony, I will argue that the Administration's proposal relating to Section 936 works at cross-purposes with U.S. policy in the Caribbean Basin. That policy aims to protect U.S. economic and security interests by fostering a stable democratic region through economic development. Furthermore, it works against the development goals and objectives of the Caribbean Basin and the many efforts underway to establish healthy free-market oriented economies.

II. BACKGROUND

Section 936 of the Internal Revenue Code of 1986 permits certain U.S. corporations to earn income that is in effect free of United States federal income tax if the income is derived either (i) in the active conduct of a trade or business in a possession or (ii) from qualified possession source investment income ("QPSII"). The Tax Reform Act of 1986, broadened the definition of QPSII to include income from investments of Section 936 funds for development projects in qualified Caribbean Basin countries. U.S. subsidiaries operating under Section 936 may deposit their earnings in banks operating in Puerto Rico and receive interest free from U.S. and Puerto Rico income taxation. Because the interest earned is tax free to the depositor, the banks offer lower interest rates for these funds.

Without QPSII treatment and 100% credit on interest earnings, there would be little incentive to deposit funds in Puerto Rico and invest in qualified Caribbean Basin countries. **The availability of funds and term resources would eventually dry up, interest rates would rise and the only source of U.S. concessionary loans to the small countries of the Caribbean Basin would be eliminated.**

III. 936/ CARIBBEAN PROGRAM SUCCESSES

Since implementation in 1987, the 936 Caribbean Development Program has achieved solid results and steadily gained momentum. Through mid-March 1993, $684.6 million worth of investments were funded by Section 936 funds in nine eligible Caribbean Basin countries representing 46 projects and approximately 13,000 jobs. It is estimated that an additional $800 million worth of investments are in the pipeline pending government approval. By year end 1993, total disbursement figures could amount to $1.5 billion.

Projects related to telecommunications, agribusiness, food processing, infrastructure, manufacturing and tourism are being financed with 936 funds. To cite some examples, 936 loans have been used to finance the expansion and modernization of Barbados' telecommunications infrastructure; the expansion of Trinidad and Tobago's airport facilities; the construction of low-income housing in Jamaica and the purchasing of equipment for Costa Rica's metal mechanic services for the power and telephone industries in Central America. These projects provide substantial benefits to the Caribbean Basin economies by creating new jobs, direct investment, technology transfer, foreign exchange earnings and other benefits in the form of indirect employment and related-support businesses. **At a time when the program is flourishing and the Caribbean Basin is struggling with few advantages, reductions in the 936 development approach would seriously undermine the region's economic goals and aspirations.**

IV. CARIBBEAN BASIN DEVELOPMENT IMPACTS U.S. ECONOMY

Caribbean Basin countries have embarked upon a historic path undertaking economic reforms necessary to stimulate private investment in the region. New leadership in the region is moving in the direction of genuine economic change committed to economic liberalization. Liberalization of trade, investment and capital flows stimulate growth benefitting both the U.S. and the Caribbean Basin. We should not overlook the fundamental fact that when investment in the region expands, imports increase and additional U.S. exports and jobs are generated.

Presently, the U.S. has a trade surplus with the Caribbean Basin countries in the amount of $2.1 billion. Combined U.S. exports to the Caribbean Basin countries in 1990 totaled $9.7 billion, rising 5.6 percent over 1989. The Caribbean Basin was the 11th-largest export market of the United States, ranking before Australia and Italy. The consistently positive U.S. trade balance with the Caribbean Basin reflects a 64.7 percent growth in U.S. exports since 1983. In 1990, this $9.7 billion in U.S. exports supported almost 200,000 American jobs. Furthermore, it is estimated that for every dollar earned in the Caribbean Basin, 60 cents are used to buy American products; compared to Asia which only spends 10 cents on the dollar. Obviously, CBI industries have a strong propensity to purchase American raw materials, machinery and equipment. On average, over 45% of all CBI imports are sourced from the U.S., the highest percentage in Latin America. Furthermore, most of the construction and procurement for 936 loan sourcing is from the United States.

The United States benefits when the economies of the region are healthy and strong. Economic growth in the Caribbean Basin creates markets for U.S. services and products. **"Improved economic growth in the Caribbean Basin is in the direct interest of the United States. It helps to create jobs and exports for the U.S. It helps to promote the ideals of democracy, which are important for us not only in our own nation, but throughout this hemisphere," said President Clinton during the 1992 Miami Conference on the Caribbean.** In this light, any measures to increase the flow of 936 funds to the region should be encouraged and enhanced; especially at a time when the region is so committed to the continuation of free-market oriented macroeconomic policies.

V. REVISITING THE CARIBBEAN BASIN INITIATIVE

Economic and political stability in the Caribbean Basin has always been important to the United States. As a result, the U.S. has promoted economic growth and economic stability embodied in two major U.S. programs, the Caribbean Basin Initiative (CBI) and Section 936. The CBI has provided a unique impetus to the development of trade and investment between the U.S. and the Caribbean Basin. The result has been an increase flow of trade and investment both ways. Perhaps most significantly, the new opportunities for trade and investment which were created within the CBI framework have inspired creative free-market oriented economic thinking in the region.

Notwithstanding, the CBI has not met all its goals of generating employment and private-sector led investment opportunities, and broadly based economic growth has not been realized. One of the major problems, from the inception of the CBI program has been the limited amount of investment incentives. To a degree, Section 936 has served this function in eligible Caribbean Basin countries. In this regard, we should seek ways to preserve and enhance those programs that stimulate trade and investment in the region and find ways to build upon the fundamental principles of the CBI.

VI. EROSION OF PREFERENCES

Although the Caribbean Basin countries positively view the North American Free Trade Agreement (NAFTA), there is deep concern that the erosion of the market access advantages enjoyed by CBI countries will adversely impact the competitive situation of Caribbean Basin economies. NAFTA, the Single European Market, the extension of trade preferences to Eastern Europe and the Andean nations and other global trade developments can threaten the economic progress that the Caribbean Basin countries have made under the CBI. The region faces a difficult transition period from an environment of special trade treatment to a future environment ruled by principles of free trade and reciprocity. The Caribbean Basin recognizes what the future holds and is taking measures within its means to meet the challenge.

The public and private sectors of the Caribbean and Central American have expressed their concern that Mexico's preferential access to the U.S. market would divert investment and trade away from the Caribbean Basin region. As **NAFTA becomes a reality and Mexican products benefit from duty-free and quota free treatment, the margin provided by 936 interest rates may become as important a factor as CBI tariff preferences in maintaining U.S. investor's interest in the Caribbean Basin.** Against this background, it has become now more important than ever to identify and preserve the unique advantages that the Caribbean Basin has to offer in this rapidly changing global trade environment. At this juncture, 936 funds are critical to the development goals of the Caribbean Basin.

VII. UPHOLDING TREATY COMMITMENTS

Another issue that I would like to raise today is related to Tax Information Exchange Agreements (TIEA) with the United States. Signing a TIEA was a precondition for eligibility to receive 936 loans. TIEAs are important to the United States because they provide the mechanism to obtain evidence against tax evaders. In order to enjoy the benefits of accessing 936 funds, these countries have had to enact amendments to their legal codes in order to permit access by the U.S. to confidential information. TIEAs are valuable in the war against drugs and they are effective in deterring drug money-laundering by creating effective tracing instruments.

To date, Barbados, Costa Rica, Dominica, the Dominican Republic, Grenada, Guyana, Honduras, Jamaica, St. Lucia, and Trinidad and Tobago, have concluded TIEA's. Without the recent developments on 936, it was anticipated that other countries would have signed by year end 1993. The reduction of 936 tax credits would limit the pool of funds available for 936 Caribbean Development projects and hence erode the linkage between signing a TIEA and accessing 936 funds. This undermines the credibility of the U.S. to uphold commitments and agreements which it has requested.

VIII. REDUCED LEVELS OF U.S. ASSISTANCE

Given events in the former Soviet Union, the Middle East and Eastern Europe, aid levels to countries in the Caribbean Basin will decline from previous levels or even be eliminated in some countries. In recent years, total USAID levels have decreased in the Caribbean Basin. In Central America, USAID levels dropped from $827.189 million in 1991 to $633.818 million, the amount which has been allocated for Fiscal Year 1993. In the Caribbean, USAID levels have also been slashed from $205.405 million to $180.558 million. Total U.S. Assistance to the region is also dropping. The availability of 936 funds reduces the region's need for U.S. aid and compensates for the lack of direct assistance from the United States. These loans buttress free-market private-sector oriented policies which enable economic growth.

Recognizing the need to improve the flow of funds to smaller regional projects, the Caribbean Basin Partners for Progress (CBPP) was established. The CBPP is a financial institution created by U.S. corporations operating in Puerto Rico under Section 936. CBPP loans are designed for small businesses which are the engine of economic growth in the Caribbean Basin. To date, the CBPP has a pipeline of 35 projects in place amounting to approximately $30 million. Most loans range in the amount of $300,000. Approximately, 65% of these loans are in agricultural projects. This type of credit replaces loans which in another day might have been provided by USAID.

Furthermore, 936 funds represent approximately $100 million in foreign exchange savings as a result of lower interest rates to eligible Caribbean Basin countries. **This substantial savings has offset the decline in direct U.S. aid.**

IX. REDUCING DRUG EXPORTS AND MIGRATION FLOWS TO THE U.S.

Lastly, numerous studies demonstrate that the incentive to migrate and to enter into drug production are directly linked to slow growth, low investment, poverty, and overall lack of opportunities in the countries of origin. Migratory movements from the Caribbean and Central America have intensified in the last decade. From 1981 to 1988, emigration from Central America and the Caribbean to the U.S. amounted to 47% of total emigration from Latin America, which represents 20% of total immigration into the United States. This is a staggering number for a group of countries that represent less than 15% of the total population of Latin America.

Countries which experience social degradation are prone to consume drugs and enter into drug production and trade as a source of income. The region is also concerned that the removal of trade and investment preferences to CBI countries not only dampens government efforts for economic reform and modernization but also has the undesirable side effect of increasing drug trafficking, notwithstanding their best efforts at intervention. This production and trade is usually targeted at the most profitable and closest market–the United States.

X. DEMOCRACY AND ECONOMIC GROWTH

In the past decade, there has been a remarkable shift towards democracy and free markets in the Caribbean Basin region. Assisting developing countries to a successful transition to pluralistic democratic government and economic liberalization has always been an overriding objective of the United States. An economically thriving and politically democratic Caribbean Basin benefits the U.S.; an impoverished and chaotic region only creates serious economic, social and security problems for the United States. The essential remedies to the latter are always more costly than preventative measures that rely on the resourcefulness of the particular country. The 936 program was designed to assist that effort and it is succeeding more dramatically than anyone envisioned in 1987.

Perhaps it is useful to note that the 936 Caribbean program, as it was born in the mid-1980's, focused particularly on the rebuilding of a politically and economically devastated Grenada. In 1993, use of these funds as an incentive for creating investment and jobs in Haiti would not only be consistent with the principles of the 936 Caribbean Program, but could be an important incentive to the establishment of new business ventures in that beleaguered island. As with Grenada, the task of reconstructing Haiti will need special measures. The 936 Caribbean program could be central to restoring the economy.

To conclude, 936 funds are an important catalyst for investment and economic development in qualified Caribbean Basin countries. The reduction of 936 tax incentives or the gradual elimination of the program undermines an important instrument of U.S. foreign policy. At a time when the region is so committed to the continuation of free-market oriented policies and democratic reform, changes to Section 936 will jeopardize an important program that is working well and helping the region realize its economic potential.

Mr. RANGEL. Thank you.

I want to thank the entire panel for its testimony. And I just have one question of Dr. Ramirez.

Doctor, you felt pretty strongly that the changes suggested by the President would not adversely affect the economy in Puerto Rico. If I knew that, I would have no problem in supporting the President. I want very badly to support President Clinton, as a matter of fact, the entire package, not just 936. And I am not convinced that 936 in the long run is the best thing for Puerto Rico, to be so completely dependent just on one section of our code, you know, to believe that one-third of the economy, the jobs are just dependent on the whim of the Congress and the President.

Having said that, since we have not had any hearings and the President has not shared with us how he reached the conclusion that this would not hurt the people in Puerto Rico, could you share with me and the committee how you have reached the conclusion this dramatic change, which will take $7 billion out of the economy, would not lose jobs or hurt the people in Puerto Rico?

Dr. RAMIREZ DE FERRER. Yes, I will answer your question and I ask you to allow me to share the answer with my colleague, Luis Costas, who is the expert on 936, and he can add a little bit to that. Is that possible?

Mr. RANGEL. Or he can handle the whole thing.

Dr. RAMIREZ DE FERRER. First of all, I want to say that for many years now we have been worried about Puerto Rico's economy. Hearing my colleague here talking about New Jersey medical services and things like that, I invite him to come to Puerto Rico and see the kind of health system we have. I work for the government, and we have lack of medicine, we have lack of essential facilities.

A baby just died a few months ago, because he could not get a respirator or an ambulance, roaming all over the island, so I——

Mr. RANGEL. Doctor, I don't think I have phrased my question correctly. I know how bad it is.

Dr. RAMIREZ DE FERRER. Exactly, so——

Mr. RANGEL. I know how bad it is and, believe me, I am not saying that 936 has worked. I am asking a very narrow question: How do you know that the removal of $7 billion from 936 would not worsen the situation in Puerto Rico?

Dr. RAMIREZ DE FERRER. Well, I don't think it could get any worse, Congressman.

Mr. RANGEL. OK.

Dr. RAMIREZ DE FERRER. And I am going to let Luis Costas answer your question.

Mr. RANGEL. Believe me, I have been to San Juan and it is worsening already, without this change.

Dr. RAMIREZ DE FERRER. Dr. Luis Costas is our vice president of our organization and a foremost expert on section 936. He did his Ph.D. in Harvard on section 936, and he can answer some of the questions——

Mr. RANGEL. Do you believe it cannot get any worse in Puerto Rico than exists now, is that your opinion?

Mr. COSTAS. I think so. For over 20 years, I have been writing not only on 936, but on 931 and its predecessor, 252. I mean all of this began in 1921, as you well know.

As it is, you are dealing with a taxation of profits. That is all you are dealing with. These people are making huge amounts of profits, and all the President is saying is let's tax some of those profits and not give them the total exclusion or tax sparing that we provide under 936.

Right now, these moneys are not really going down to the average man and woman on the street. That is why our conclusion is that it is not helping the average man and woman on the street, then nothing is going to happen. The same way that in 931, these creatures of doom said when you change from 931 to 936, the sky will fall, and it did not.

Mr. RANGEL. I see.

Mr. COSTAS. We have included, and you have accepted to be included, the president of the Puerto Rico Government Development Bank actually presented statistics and made that same conclusion, there will be no doom. The editorial, the owner of the largest Spanish newspaper in Puerto Rico came to that same conclusion, and Caribbean business.

Mr. RANGEL. These people are saying that, as a result of this lavish loophole in the Tax Code, that they are losing jobs to Puerto Rico, and you are saying that it really does not make any difference to Puerto Rico, that the people are not benefiting.

Mr. COSTAS. Correct.

Mr. RANGEL. Very good.

Mr. COSTAS. Not only that, but what we are saying is that if you really want to help Puerto Rico, why do you need a 936 intermediary? Why does the United States——

Mr. RANGEL. It is giving you $7 billion.

Mr. COSTAS. Right. Why does the United States want to spend $3 billion a year? Most of that money stays in the pockets of the 936 corporation intermediaries, and you expect those moneys to somehow trickle down to the average man on the street. The only way it trickles down is through compensation, and you know the huge differentials, $70,000 per employee just to pay somebody——

Mr. RANGEL. So your point is if the companies were not receiving the tax breaks in Puerto Rico, that they will be manufacturing in the United States and we could tax them here, is that your point?

Dr. RAMIREZ DE FERRER. I am sorry, but I don't think we are so bad, as people and workers, that they won't be stimulated to stay there. As a matter of fact, they pay less salaries in Puerto Rico than they are paying in the United States, anyway, and we just found out that most of them are temporary Kelly or whatever services, so I don't see why they would be running away back to the United States, if we had the same conditions in the United States. Florida doesn't have 936 and they still have a 6-percent unemployment rate, and we have 18.

Mr. RANGEL. If that is what you believe. I just wanted to know what was the basis of your belief, that is all.

Mr. COSTAS. May I add, sir, that even in the pharmaceutical companies, there is a $4 wage differential. In other words, the same company in the United States will pay $12 or $13 to its employees per hour. Yet, that same pharmaceutical company in Puerto Rico, even with the benefits of 936, will pay only around $7, so there is still a wage incentive.

Mr. RANGEL. So you are saying if we took away 936, they will still be there?

Mr. COSTAS. Yes.

Mr. RANGEL. I understand.

[The following was subsequently received:]

PUERTORICANS IN CIVIC ACTION
PUERTORIQUEÑOS EN ACCION CIUDADANA

Miriam J. Ramírez de Ferrer MD
President

April 6, 1993

To: Congressman Dan Rostenkowski
Ways and Means Committee
US House of Representatives
Washington DC 20515

From: Miriam J.Ramirez de Ferrer MD
President, Puerto Ricans in Civic Action

During the April 1, 1993 hearing held by your Committee, Congressman Rangel asked us a question which we did not have the time to answer properly.

We are hereby answering Congressman Rangel's question and request that it be included for the record of the April 1,1993 hearings on President Clinton's Economic Proposals:

<u>Congressman Rangel's question:</u>

" Can you show me how the elimination of Section 936 will not create havoc with Puerto Rico's economy ? "

<u>Our Answer:</u>

Not only is the elimination of Section 936 not going to affect our economy negatively, but in fact, it will create the biggest boom we have ever had.

The key issues here are the following:

1. By offering a wage credit instead of a tax gimmick, the focus by the manufacturers will be on additional jobs to get more credits rather than fewer jobs to increase profits. This will encourage and increase employment in companies which qualify for this tax credit and will boost the economy.

2. By settling the question of Section 936, there would once again be confidence in the economy. This will promote investment which in turn will create more jobs. (You mentioned so eloquently during the hearings that Puerto Rico's economy is held hostage by the decisions of the US Congress. Well, we finally have the opportunity to eliminate this problem by finally having the type of program going for us that is currently being considered for other States in the " Enterprise Zones" which you have proposed.)

We also ask you to refer to the paper by Mr.Alexander Odishelidze which was entered in the Congressional record during our testimony

[THE PAPER BY MR. ODISHELIDZE IS BEING RETAINED IN THE COMMITEE FILES.]

P.O. BOX 3225 • MAYAGUEZ, PUERTO RICO 00681 (809) 834-0726

Mr. RANGEL. Mr. Pickle.

Mr. PICKLE. Mr. Chairman, I want to express my appreciation to this panel for coming, particularly some of you who at least tried to raise a different approach to it.

Dr. Ramirez, I notice that you have mentioned the interest that my subcommittee had made in this area, so I appreciate the fact of you making that observation.

It certainly is a breath of fresh air on this whole subject, so I appreciate the courage and the interest that you have shown in trying to find a different answer.

I want to ask you, if companies could not get a tax credit for interest income earned on money on deposit in the private banks, in Puerto Rico, what would happen to those companies? Would they stay down there?

Dr. RAMIREZ DE FERRER. I am going to let him help me answer that. But when I was hearing the bankers a little while ago and I heard about all these loans sending it out to the people, that is not true. I think they are paying maybe 3 or 4 percent to the corporations, but they are lending it out at 10, 11, and 12, so they are making a lot of money on that. And I am hearing all of this about the mortgages and everything——

Mr. PICKLE. Can you substantiate that to us with some figures?

Dr. RAMIREZ DE FERRER. I think so, but I would let our expert tell you more about that.

Mr. MUNOZ. I would just like to make one point. As you recall, over the last 50 years, with Puerto Rico becoming a commonwealth and with various incentives, there has been a tremendous development. Anyone who has traveled out of the United States and gone from San Juan, PR, to the Dominican Republic, which is a separate country from the United States, to Port-au-Prince, Haiti, and looked at those three economies and said what's the difference, why is there such a dramatic difference between Haiti, the Dominican Republic, and then finally Puerto Rico phasing into a more Western type economy, has to ask the logical reasonable question, why has this occurred.

I don't believe that it was magic. It occurred because of policies by the Federal Government such as 936 that have helped that progression and in a very humane way, and I think it is illogical to think otherwise.

Mr. PICKLE. Dr. Ramirez.

Dr. RAMIREZ DE FERRER. I am sorry, but I would rather be compared to a State of the Union, since we have been part of the United States for 100 years. I don't want to be compared to Haiti and Santo Domingo. And maybe you go to San Juan and see some really nice hotels and nice beaches, but I am inviting you to go out 3 hours into the island where I live and come and see what it is like over there.

I would like our attorney to answer the last question.

Mr. COSTAS. Sir, recently the Internal Revenue Service published U.S. possession corporation returns for 1989, and I am looking at the table on the drug companies and I am reminded of a comment by Nobel Prize winner James Tobin who came in 1975, under former Governor Hernandez-Colon, and the published report to the Governor in 1975, the committee to study Puerto Rico's finances.

He pointed out that the then-931 companies looked like mutual funds and that this idea that somehow the Puerto Rican Government could utilize the 931 funds to lesser interest rates in Puerto Rico was not true, that, in point of fact, money moves around the world dependent upon whatever interest rates you can get and they will stay wherever they make a profit. And he said it was much better to tax them and utilize them by the Government in the various programs you have.

You look at that comment by Professor Tobin in 1975, and we are now in 1993, and I look at the U.S. possessions' corporations report, universal returns from 1989, and you will look at exactly the same situation that prevails today. They do look not like manufacturing companies, but like mutual funds. Of the $12 billion in assets, they have $2 billion in cash, and then they have all the rest in investment in U.S. Government obligations, tax-exempt securities. And of that entire $12 billion, when you actually get to depreciable assets, it is only $2.7 billion. Around $10 billion of the $12 billion is in financial instruments.

Mr. PICKLE. That is a lot of money.

Mr. COSTAS. It is a lot of money. Now, certainly, there must be better ways, of all these wise people here, to actually help Puerto Rico, and by Puerto Rico, I don't mean 936 Fortune 500 corporations. I mean the little man in the street.

Mr. PICKLE. Mr. Chairman, I know our time is short.

Did you wish to make a statement?

Mr. NUNEZ. Yes, Louis Nunez, of the National Puerto Rican Coalition.

I think we should be clear that what is being presented by the good doctor from Puerto Rico is very distinctly a minority position. I think we had a representative from the bankers association a little earlier on who pinpointed where that money is invested and the fact that it is, in fact, of benefit to the common person in Puerto Rico. 936 companies employ over 115,000 people in Puerto Rico. That does not include the indirect jobs, which are over 200,000.

Mr. PICKLE. We are not approaching this question on the basis of does it help Puerto Rico. The question at this point is, is it fair and how is it operating, and have we reached the point where we ought to make a change as far as approach is concerned. That is the test, and not whether how you are using the money, and that is what we have to keep in mind.

Mr. Chairman, I thank you.

Mr. KOPETSKI [presiding]. Mr. Sundquist may inquire.

Mr. SUNDQUIST. Thank you, Mr. Chairman.

I thank all of the panel for their testimony—and particularly Mr. Tucker who is from my district. He has led his union in a fight to keep a plant in our area.

Mitchell, you heard my questioning earlier of some people representing different aspects of Puerto Rico. There were no Government officials here, as such. Could you outline for me what I understand is your frustration in not being able to understand how this law works? It is not U.S. law that governs the runaway plants. It is the Puerto Rican law that ostensibly would prevent runaway plants. Can you tell me if that is effective or not effective?

Mr. LEONARD. Maybe I could respond. This is rocket science and it took me a couple of years to figure it out myself.

Puerto Rico has its own tax jurisdiction and their own set of tax laws and a tax rate that is about as onerous as the one in the United States on corporations.

In their Tax Incentives Act, which dates back to Operation Bootstrap in the early 1950's, when they first set up this system for local incentives, they recognized that there could be a lot of obstacles from the mainland concerning the possibility of runaway plants to Puerto Rico. There was quite a debate here in Congress at that time over the issue.

So they put a clause in their tax law that has remained there ever since that basically states that the folks in Puerto Rico cannot give a local Puerto Rico exemption, if it should have an adverse effect on the applicant's employment on the mainland. It was put in there basically for that purpose and has been in there ever since. It has been highly ineffective.

In fact, recently a public relations employee for Fomento pointed out that it was a public relations gimmick and basically unenforceable. We had the opportunity to depose a number of officials during a recent lawsuit, a number of officials including the local tax exemption office, over this very question, and they said of the thousand or so tax exemption applications that they have seen in Puerto Rico, in no case did one company ever admit to dislocating a single worker from the mainland as a result of getting the local tax exemption.

The local tax exemption, of course, is the first step to getting 936 qualification. You must have it. Without it, 936 is useless. But the local statute has completely failed. It has not worked, it has never been applied, and it is only recently that a number of workers like Mitch Tucker and others from Elkhart, IN, have discovered this law and the fact that it has been abused and ignored and have tried to take action to correct it. That is why we are here today.

Mr. SUNDQUIST. Mr. Stark's bill, H.R. 1210, as I understand it would amend 936, and allow the Secretary of the Treasury to withhold or revoke section 936 on income earned by a runaway plant.

Mr. LEONARD. That is correct, sir.

Mr. SUNDQUIST. So that would then change the responsibility within Puerto Rico. As I understand it, Mr. Tucker, when I was with you, you could not even get an appointment with the governmental officials or could not talk with them, as I recall?

Mr. TUCKER. That is right.

Mr. SUNDQUIST. So they would not respond to you, and that is the frustration I had earlier in asking for that information. Now, apparently you have deposed some individuals down there since then.

Mr. LEONARD. No, this was the matter of a lawsuit of last year. Our union took the American Home Products Co. into court over this very issue, and as a result of our discovery on them, we were able to understand how this whole process works.

In this particular case, our union and Mitch's union have both written to the local tax incentives office, asking for something as simple as a copy of the tax grant. The tax grant is basically a document that says we are going to give you this kind of tax break, if

you will employ this many people. It should be a public document. They have written back and they have absolutely stonewalled our requests for these very fundamental documents.

Mr. SUNDQUIST. If you would write to the Delegate from Puerto Rico with all the questions you want answered and send that to me, I will hand deliver it to the representative here. That was the consensus here, that that representative would get those answers for us. I would like to have your requests for information made part of this record of the committee, so it is on record, together with the statements made by people who were representing Puerto Rico's interests here, so we can make sure at some later point that you do get those documents and you do get the information that you are entitled to. I think that is only fairness.

Mr. LEONARD. Your suggestion is that we write who? I'm sorry, you were asking us——

Mr. SUNDQUIST. Write to the Delegate from Puerto Rico.

Mr. LEONARD. The Resident Commissioner?

Mr. SUNDQUIST. No, to the Delegate to the Congress.

Mr. LEONARD. That is the Resident Commissioner.

Mr. SUNDQUIST. Right, the Resident Commissioner.

Mr. LEONARD. We have communicated with him on this issue, as well.

Mr. SUNDQUIST. Send that to me. Mr. Chairman, could I have that introduced in the record, when those questions come to me?

Mr. KOPETSKI. Without objection.

Mr. SUNDQUIST. Thank you.

[The information referred to follows:]

OCAW

Oil, Chemical & Atomic Workers
International Union, AFL-CIO

Robert E. Wages, President
Ernest J. Rousselle, Secretary-Treasurer
L. Calvin Moore, Vice President
Paul T. Lindgren, Vice President
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April 13, 1993

Representative Carlos Romero Barcelo
Resident Commissioner, Puerto Rico
1517 Longworth House Office Building
Washington,DC 202515-5401

Dear Representative Romero Barcelo:

I am writing on behalf of United Rubber Workers Local Union 330 and 480 workers in Clarksville, Tennessee who will be losing their jobs when the Acme Boot Company closes its doors in May.

As you know, there has been an ongoing controversy with the Puerto Rico Office of Industrial Tax Exemption over Acme Boot's application for tax exemption.

In an effort to clarify this issue, a request for copies of various documents was made of the Tax Exemption Office citing Governor Rossello's Executive Order No. 3 on open records. On January 20, we were informed by Mr. Andaluz Garcia, Sub-Director of the Office that none of the requested documents were considered public.

For these reasons, I am seeking your assistance in obtaining this material:

1) Copies of all petitions or applications for industrial tax exemption and any exhibit(s) that may be appended thereto.

2) Copies of all draft decrees or draft grants for industrial tax exemptions.

3) Copies of the Report of the Special Examiner with respect to aforementioned petition(s).

4) Copies of the Reports of the Puerto Rico Economic Development Administration with respect to the aforementioned petition(s).

5) A list of all other agencies that were sent copies of the petition and/or related materials for the purpose of keeping said agencies informed or for the purpose of seeking comment on approval from said agencies.

6) Copies of reports of other agencies on the petitioner's application for tax exemption.

7) Copies of all correspondence between the petitioner and the Office of Tax Exemption concerning any of the documents or procedures in items 1-6 above.

I thank you for your concern over this issue and extend the appreciation of 480 workers in Clarksville, Tennessee for your efforts on their behalf.

Sincerely yours,

Richard Leonard
Special Projects Director

RL/mm

Mr. SUNDQUIST. Thank you, Mr. Chairman.

Mr. KOPETSKI. Thank you very much.

I really want to thank the panel for taking time from their busy schedules. It was excellent testimony and I am sure all the issues got before the committee because of you.

Thank you very much.

Mr. SUNDQUIST. Mr. Chairman, could I also have the letters entered in the record with the questions?

Mr. KOPETSKI. Absolutely. Without objection, so ordered.

The next panel, if they would come forward, we have a representative from the National Foreign Trade Council, John E. Pepper, president, Procter & Gamble Co.; the Royalty Coalition, Thomas Bretz, national director, international tax policy, from Price Waterhouse; committee on royalty taxation, Dexter F. Baker, chairman, executive committee, board of directors, Air Products & Chemicals, Inc., from Allentown, PA. the Deferral Preservation Coalition, Paul Oosterhuis, counsel; and Tambrands, Inc., White Plains, N.Y., Anthony J. Principato, vice president of taxes.

We are under a vote and I would like to get the first witness' testimony in, if at all possible, before I have to leave for a vote. I am hoping that we will not have to take a recess.

I should inform the panel that there is as lighting system, it is a 5-minute lighting system. Your entire testimony will be made a part of the record. We ask that you try to summarize in 5 minutes. The little red light is the ejection seat button.

Mr. Pepper, welcome. Thank you very much for joining us today.

STATEMENT OF JOHN E. PEPPER, PRESIDENT, PROCTER AND GAMBLE CO., ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. PEPPER. Mr. Chairman and members of the committee, my name is John Pepper, president of the Procter & Gamble Co. I am here today on behalf of the National Foreign Trade Council, of which Procter and Gamble is a member.

The National Foreign Trade Council is a trade association founded in 1914. Its 500 members are primarily U.S. corporations engaged in international business. Its purpose is to promote policies which enhance the members' and the Nation's global competitiveness.

Overall, we strongly support the administration's economic objectives for accelerated economic growth, job creation and significantly reduced deficits. The council is concerned, however, that the more than $100 billion of added corporate tax increases might dampen economic recovery and job creation.

Our written statement addresses several proposals in the administration's plan. I am going to limit my comments today to one subject, the proposed treatment of foreign operating royalties as passive income. I respectfully submit that this proposal is contrary to sound tax policy. In practice, we don't believe it will generate significant revenue, but, rather, it will produce results exactly opposite to those that the administration seeks to accomplish.

First, it will cost U.S. jobs—high-paying high-tech jobs. Second, it will significantly reduce cash flows to the United States. Third, it will increase taxes of U.S. multinationals, but not of their foreign

competitors, reducing our global competitiveness. And fourth, it will provide a tax disincentive for conducting research and development in the United States.

The royalty proposal severely hits those companies which receive both dividends and active royalties from abroad. These companies are critical contributors to this Nation's economic progress. They are operating globally, typically in high-technology fields, and, as other testimony is going to make clear, they provide this Nation with a growing positive balance of trade and payments.

This proposal will require that these companies separate their active royalty income from other active foreign income for foreign tax credit purposes. This would reverse tax policy that has existed for decades in this country and that exists in every one of our principal competitors' countries. By preventing U.S. multinationals from using otherwise available foreign tax credits, active income already taxed abroad would be further taxed in the United States, frequently resulting in taxes in excess of 50 percent.

I want to emphasize that current tax policy does not specially favor companies receiving dividends and royalties from abroad. Their overall tax rate on these remittances is in no case lower than the statutory rate of 34 percent. Believe me, multinational companies like my own are in a head-to-head battle for global business every day with multinationals from all parts of the world. The profit margins are tight and pricing is extremely sensitive, especially in today's weak economy.

For this reason, there is absolutely no way to pass on the higher taxes that this proposal imposes through higher prices. Also, these taxes could not be absorbed through lower profit margins, without eroding shareholder value and investment in future jobs. So there would be no recourse but for a company to cut expenses to remain competitive. For one thing, companies will consider eliminating U.S. jobs or relocating them abroad to reduce their after-tax costs. Licensing U.S. technology abroad will also become less attractive, risking further erosion of U.S. jobs and technology.

The other way that this change could harm our country's interest is by significantly reducing cash inflows to the United States. Royalty income today is estimated at $15 to $16 billion per year. I guarantee you that it would decline dramatically, if this is enacted.

So, too, we predict will dividend flows, further hurting our balance of payments. That is because companies in excess foreign tax credit position will be unable to credit foreign withholding taxes that are levied on dividends. That will be an added expense which they will move as quickly as they can to avoid. Perhaps most importantly, this change will lead to an erosion of the U.S. technology base over time. We can imagine nothing more counter to our national interest.

In conclusion, we deeply believe that the proposed change unwisely places an unmanageable tax burden on technology based global companies which must play a leadership role in the growth of our economy. To remain competitive, these companies will have no choice but to work quickly to restructure their organizations and cash flows. We believe the United States will lose jobs, will lose capital and technical capability, with little, if any, net revenue to the government.

I truly believe that this is a lose-lose situation, not what the administration seeks to encourage, or what the Nation needs. I am certain that there are better ways to raise the revenue that this seeks to provide.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF
THE NATIONAL FOREIGN TRADE COUNCIL, INC.
PRESENTED TO THE HOUSE WAYS AND MEANS COMMITTEE
ON THE ADMINISTRATION'S ECONOMIC PROGRAM AND
DEFICIT REDUCTION PLAN

Mr. Chairman, and Members of the Committee:

The National Foreign Trade Council, Inc. (NFTC) is pleased to present its views on the Clinton economic program and deficit reduction plan (the "Administration Plan").

The NFTC is a trade association with some 500 members, founded in 1914. Its membership consists primarily of U.S. corporations engaged in all aspects of international business, trade, and investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad.

The Administration's economic program and deficit reduction plan are of immense importance to the NFTC and its membership. The NFTC commends the Administration for its bold approach to deficit reduction. NFTC's membership would benefit from a drop in interest rates that reduction in the federal budget deficit could bring.

However, our support for deficit reduction does not mean that we embrace the plan in its entirety. In fact, we believe that certain provisions in the international area would be highly detrimental to U.S. companies seeking to expand or maintain market share abroad. NFTC believes that the mix of spending cuts and tax increases should be tilted more heavily in favor of spending cuts. Moreover, proposed tax increases should not impede the ability of the business community to provide the job growth the President seeks or impair the competitiveness of U.S. companies operating abroad.

In particular, the NFTC believes that selective, piecemeal revisions to the tax rules governing international transactions will only create additional complexity and unintended, harmful consequences. The NFTC instead favors comprehensive reform of the international provisions of our tax system. The process for reform of the international tax rules was given a major boost last year when Chairman Rostenkowski and then Congressman Gradison introduced H.R. 5270, the Foreign Income Tax Rationalization and Simplification Act of 1992. While we recommended certain changes to H.R. 5270 in our testimony before this Committee last year, we strongly urged that the process of comprehensive reform of the international tax regime continue. We also note that the Treasury study released earlier this year recommended that a comprehensive review be undertaken of the U.S. system for taxing international income. It is a widely accepted fact that the international tax rules have become exceptionally complex, administratively burdensome, and have made it more difficult for U.S. companies to compete in the U.S. and abroad.

Unfortunately, the international provisions in the Administration Plan do not represent a comprehensive reform of those rules, but instead reflect piecemeal modifications of our international tax provisions. Moveover, the increased revenue attributable to the international provisions in the Administration Plan is used to fund other tax relief measures unrelated to the international area. Last year, Chairman Rostenkowski made it clear that he would strongly oppose allowing provisions in H.R. 5270 that increased revenues to fund tax revisions outside of the international area. At the very least, NFTC believes that this rule should be followed by the Ways and Means Committee in its consideration of the Administration's economic plan.

OVERVIEW OF STATEMENT

The purpose of the NFTC is to promote trade and tax policies that will encourage U.S. exports and promote the ability of our companies to compete for market share in a global economy. As a consequence, the thrust of our testimony and written statement will concentrate on the international provisions in the Plan. In that respect, of profound concern to the NFTC membership is the proposal to move royalty income into the passive income limitation basket for purposes of calculating the foreign tax credit. While our written statement will principally address the international provisions in the Clinton plan, we will briefly comment at the end of the statement on other provisions that have a significant effect on the international competitiveness of U.S. companies.

INTERNATIONAL PROVISIONS

I. **Allocate Research and Experimentation (R&E) Expense to Place of Performance and Treat Royalties as Passive Income for Purposes of the Foreign Tax Credit Limitation**. The NFTC strongly opposes the proposal to shift foreign source royalty income to the separate foreign tax credit limitation basket for passive income. The proposal would apply to "active" royalty income received from either related or unrelated parties. While the NFTC is pleased with the proposed allocation of 100 percent of the research and experimentation expenses (R&E) to the country in which the R&E is performed, the benefits of this proposal are overwhelmed by the devastating impact to U.S. companies operating abroad that the proposal to move royalty income to the passive income limitation basket would cause. In our view, a far better result would be achieved if the proposal to allocate royalty income to the passive basket were dropped and a permanent extension of Section 864(f) were adopted by ruling or regulation to continue the allocation of 64 percent of R&E expense to the country where the R&E is performed.

The proposal applies to any U.S. company that licenses intangibles abroad. For this reason, the impact of the proposal transcends specific industry lines. The proposal would apply to the licensing of computer software technology, consumer products, and, for no valid conceptual reason, to trademarks and copyrights. Yet, our concern is not just the breadth of the proposal and its potential impact on most NFTC member companies operating abroad, but also the magnitude of the tax increase that the proposal would impose on U.S. multinational companies. (Emphasis supplied) Based on a random sample of NFTC member companies, this proposal would translate into the equivalent of a 5 to 20 percent corporate tax rate increase on foreign source income beyond the 2 percent rate increase from 34 to 36 percent on all income proposed in the Administration Plan. Due to the number of NFTC companies affected by the proposal and the extent of the tax increase that the proposal would cause to many NFTC member companies, NFTC expresses its opposition to the proposal to allocate royalty foreign source income to the passive limitation foreign tax credit basket in the strongest possible terms. (Emphasis supplied)

A. **Why the Current Law Rules on Royalty Foreign Source Income Should be Maintained**. The NFTC believes that both the policy rationale and the practical effects of the present law treatment of foreign source active royalty income further both the interests of U.S. competitiveness abroad and also the U.S. Treasury.

1. **Present Law Encourages the Remittance of Foreign Earnings to the U.S.**. The so-called "look-through" rule of current Code Section 904(d)(3)(C) encourages the remittance of earnings from a foreign subsidiary to the U.S. parent company. By granting the U.S. parent company a foreign tax credit on active income earned by its foreign subsidiary, the "look-through" rule essentially treats the U.S. parent company as if it had earned the profits from which the distributions from the foreign subsidiary (royalties, rents,

interest, and dividends) are made. Consequently, the character of the income from which the foreign subsidiary distributes profits to the U.S. parent company remains the same in the hands of the parent company as it was to the foreign subsidiary.

In the case of royalty income, present law appropriately provides that royalties from a wholly-owned foreign subsidiary that earns only active business profits would be treated as active income producing a foreign tax credit subject to the overall limitation foreign tax credit basket. The ability of U.S. parent companies to receive a foreign tax credit on earnings remitted from foreign subsidiaries in the form of royalties (and other income) permits U.S. multinationals to repatriate the income earned overseas to the U.S. without adverse tax consequences <u>This policy of permitting the repatriation of overseas funds promotes investment in the U.S., assists companies in raising capital in this country, and promotes jobs and productivity in the U.S. If the so-called "look-through" rule for royalty income is repealed (as proposed by the Administration), a disincentive to return capital to the U.S. would be created</u>. (Emphasis supplied)

Although the Administration proposal to allocate foreign source royalty income to the passive limitation basket technically would not repeal the foreign tax credit, the effect would be to create excess foreign tax credits for U.S. companies that remit earnings to the U.S. in the form of royalties. Under the proposal, U.S. companies that currently have excess foreign tax credits would see the number of excess foreign tax credits multiply, and U.S. companies that currently do not have excess foreign tax credits would likely face the imminent prospect of excess credits. As a result, the proposal would discourage the remittance of foreign earnings through royalty payments and instead would encourage the reinvestment of those earnings in the countries where the income is earned. At a time when the U.S. savings rate is at an all-time low and U.S. companies are desperate for capital to invest in plant and equipment in this country, the NFTC believes that the royalty proposal would be an extraordinarily ill-advised reversal of U.S. tax policy.

2. **<u>Current U.S. Treatment of Active Royalty Income Promotes the Licensing of Intangibles in Industrialized Countries</u>**. The present "look-through" rule, which permits U.S. parent companies to claim a foreign tax credit on active income earned by a foreign subsidiary through royalty payments, allows U.S. companies to more effectively compete with their foreign counterparts in the licensing of technology and other intangibles in industrialized countries. It is an unassailable statement of fact that most royalty income is generated in developed countries, such as Germany, France, Japan, etc., where the corporate tax rate and the average wages of employees exceed that of the U.S. The licensing of U.S. intangibles with our major trading partners promotes U.S. jobs, reduces this nation's balance of trade deficit, and stimulates the reinvestment of foreign earnings in the U.S. by means of the look-through rule.

Licensing of intangibles by U.S. companies invariably requires a foreign presence in developed countries. The foreign presence may take the form of a distributorship, a marketing entity, a manufacturing facility, or a servicing outlet. The business decision regarding the type of foreign presence in a developed country is based largely on nontax factors. These factors may include the desire to reduce transportation costs, access to natural resources, a need to market the product locally, or national or local law that require a certain foreign presence to do business in that country. Since royalty income is derived from the licensing of intangibles in <u>developed</u> countries, such as Germany, France, Japan, etc., where the corporate tax rate and the wage rate for employees exceed the U.S. rate, it follows <u>ipso facto</u> that the decision regarding the nature of the foreign presence is not driven by the desire to reduce taxes or to hire cheap labor.

Consequently, it is patently false to argue that the Administration's proposal to allocate royalty income to the passive income limitation basket for the foreign tax credit is a version of "runaway plant" legislation, which implicitly suggests the relocation of U.S. plants and facilities to low-tax, low-wage jurisdictions.

3. **Current Law Treatment of Active Royalty Income Earned Abroad Reduces Excessive Taxation on U.S. Companies Operating in Developed Countries**. The fact that royalty income is, in many cases, more lightly taxed by foreign countries than other income means that the excessive burden of taxation imposed on the integrated operations of U.S. owned foreign subsidiaries is lessened somewhat. Numerous studies have shown that U.S. companies operating abroad through foreign subsidiaries are taxed at a higher rate than foreign multinationals with which they are competing.

A 1991 report prepared by Price Waterhouse for the National Chamber Foundation found that U.S. companies already face "a significantly higher effective tax rate on foreign income than would a similarly situated multinational company from Canada, France, Germany, Japan, the Netherlands or the UK." (U.S. International Tax Tolicy for a Global Economy, April 15, 1991). Similarly, the U.S. General Accounting Office estimated that the effective corporate tax rate on the worldwide income of U.S. multinational corporations was 37.1 percent for 1989. The higher rate of tax on the foreign income of U.S. companies is attributable to a number of factors including: a higher corporate tax rate in many developed countries, restrictive interest allocation rules that contribute to excess foreign tax credits and a disallowance of interest expense allocated to foreign jurisdictions; numerous foreign tax credit limitation baskets; etc. In the same GAO report, it was noted:

> "One of the most important disincentives to foreign investments by U.S. companies is the potential for double taxation inherent in the myriad foreign tax credit limitations and other special rules that can operate to impose U.S. tax on foreign source income that already has borne a foreign tax in excess of the U.S. rate."

The lower rate of tax that may be imposed on royalty income earned abroad does not mean that the overall tax burden on income from the integrated operations of a U.S. controlled foreign subsidiary is low, but rather that the excessive level of taxation imposed on those earnings is moderated to a certain extent. There is no circumstance under existing law in which the combination of royalty payments and the receipt of active income from foreign production will be taxed at a lower rate than the U.S. rate. (Emphasis supplied)

4. **Current Law Only Permits "Active" Royalty Income to be Treated as Part of a Company's Business Profits for the Foreign Tax Credit**. Under present law, U.S. companies may only include "active" royalty income, whether received from related or unrelated parties, in the overall basket for active business income in calculating the foreign tax credit. As previously discussed, if the royalty is received from a controlled foreign corporation (CFC) of the U.S. parent, the character of the royalty income is determined by "looking-through" the royalty income to determine the character of the earnings from which the royalty is paid. In most cases, the income is properly characterized as active royalty income. If royalty income is received by the U.S. parent company from an unrelated party, then the character of the royalty income is determined under Treasury Regulation Section 1.954-2(d)(1) under a facts and circumstances test that examines the extent to which a CFC marketed the intangible if it did not develop the intangible itself.

NFTC believes that the current law definition of "active" royalty income represents the appropriate policy result. It is irrefutable, in our judgement, that royalty income from the licensing of intangibles or with respect to an intangible that the taxpayer markets effectively is "active income." On the other hand, the NFTC believes that it is entirely appropriate under present law that royalty income from intangibles that the taxpayer did not develop or market effectively should be allocated to the passive income limitation basket. The Administration's proposal would allocate "active" royalty income to the passive income limitation basket, to which it does not properly belong.

5. **The Present Law Treatment of "Active" Royalty Income Tends to Increase Residual U.S. Taxation**. Since U.S. tax policy is to tax the worldwide income of U.S. companies, the policy of permitting a foreign tax credit under the "look-through" rule for royalty payments from foreign subsidiary to a U.S. parent company tends to increase the likelihood of residual U.S. taxation on foreign earnings. If the policy is reversed by allocating royalty income to the passive limitation basket for the foreign tax credit, then the likely consequence of that decision will be for earnings to be reinvested in foreign countries with less residual income repatriated to the U.S. Or, alternatively, earnings will be repatriated as dividends, which will contain a higher deemed paid foreign tax credit because no royalty was charged. This scenario would be likely to increase foreign taxation and reduce tax payments to the U.S. Treasury.

B. **Reasons for NFTC Opposition to the Proposed Allocation of Active Royalty Income to the Passive Income Basket for the Foreign Tax Credit**. Beyond the reasons already articulated for retaining the present law treatment of active foreign source royalty income, the NFTC opposes the proposed allocation of active royalty income to the passive income limitation basket for the following reasons.

1. **The Tradeoff Between the Increased R&E Allocation to U.S. Sources and the Allocation of Foreign Source Royalty Income Should be Rejected**. The proposal to allocate active foreign source royalty income to the passive income limitation basket is tied to a proposal that would allocate 100 percent of the R&E expense to the country in which the R&E is performed. As previously noted, the NFTC is generally pleased with the proposed allocation of a 100 percent of R&E to the country of performance. However, when the allocation of R&E is coupled with the proposed allocation of royalty income, the balance is heavily weighted against U.S. companies that license intangibles abroad. In many cases, NFTC companies have reported that the tradeoff would be on a 10 to 1 basis against the interests of U.S. companies operating abroad.

In addition, while most U.S. companies conduct their R&E activities in the U.S., there are a number of cases in which the purported connection between the deduction of R&E expenses in the U.S. and the allocation of royalty income abroad are absent. For example, if a company licenses an intangible, such as a copyright or a trademark abroad, the company will not have incurred R&E expenses in the United States. However, under the proposal, the company, nevertheless, would be forced to bear the higher tax burden on its royalty income abroad for licensing the trademark or copyright.

2. **The Proposal will Create an Artificial Distinction Between CFCs and Branch Operations**. The proposal would create a distinction between income generated from royalty payments by controlled foreign corporations (CFCs) and income received by U.S. parent companies from a foreign branch. Under the proposal, "active" royalty income received from a CFC would be allocated to the passive income limitation basket for calculating the foreign tax credit. On the other hand, branches of U.S. companies could acquire intangibles as tax-free capital contributions. Any income generated by the intangible would be allocated to the active, overall limitation basket for calculating the foreign tax credit.

There is no logical basis for assigning a different character to the income that is produced, due to a difference in entity. In fact, this situation was one of the reasons "look-through" rules were made applicable to royalties.

3. **The Proposal would Create a Better After-Tax Result for Manufacturing Overseas Rather than in the U.S.** The proposal represents an enormous tax increase on U.S. companies that license intangibles abroad. The impact of the proposal would fall unevenly depending on the company and the country or countries in which it is operating. The reason for the magnitude of the tax increase stems from the fact that the proposal would tend either to create excess foreign tax credits for U.S. companies operating abroad or would greatly increase the number of excess foreign tax credits that a company may have. To reduce the amount of foreign tax credits, it would be incumbent on a company to explore the option of moving manufacturing facilities offshore.

4. **The "High-Tax Kickout" Rule Should be Modified to Reflect the Allocation of Foreign Source Royalty Income to the Passive Income Limitation Foreign Tax Credit Basket.** The high-tax "kickout" rule of Section 904(d) for passive income must be adjusted to reflect the proposed allocation of foreign source royalty income to the passive income limitation foreign tax credit basket. The current high-tax rules allocate to the overall limitation basket passive income that exceeds the U.S. individual or corporate income rate. If the current "high-tax kickout" rules are not adjusted to reflect the impact of the royalty proposal in the Administration's Plan, then high-tax royalty income will be reallocated to the overall limitation foreign tax credit. This result would compound the problem of excessive taxation for U.S. companies, especially those companies operating in high-tax, high-wage jurisdictions.

II. **Transfer Pricing Compliance Initiative.** Generally, the NFTC supports the concept of requiring taxpayers to provide contemporaneous documentation to support their use of transfer pricing methodologies in order to avoid the substantial understatement penalty under Section 6662(e). The NFTC believes that some form of recordkeeping requirement is a reasonable tradeoff for continued adherence by the U.S. to the arm's length method for resolving transfer pricing disputes. Unlike the comparable profit interval contained in the previous proposed regulations or the minimum taxable income concept for foreign-owned companies contained in H.R. 5270, the arm's length standard is nondiscriminatory between domestic and foreign taxpayers and is widely accepted by our trading partners as the appropriate means for resolving transfer pricing disputes between countries. Without the arm's length standard, double taxation will invariably be the result as countries adopt formula approaches to obtain maximum revenue in transfer pricing disputes between sovereign jurisdictions.

Many U.S. multinationals which are members of the NFTC,however, have expressed strong concern that overly broad contemporaneous documentation and recordkeeping requirements could create an enormously uncompetitive administrative burden on their international operations. They believe that certain aspects of the proposed regulations, if adopted by the Clinton Administration, would make it extremely difficult, if not impossible, for them to comply. For instance, a requirement to collect third party data to substantiate the taxpayer's transfer pricing results by the time the taxpayer files its tax return is simply an unconscionable administrative burden to impose on the tax return filing process. It is simply unreasonable to require taxpayers to collect and analyze third party information in order to file their own tax returns without risk of substantial penalties.

The enormous administrative burden on U.S. multinationals suggested by the penalty regulations is illustrated by the following simple example. A U.S. multinational which distributes its products

through separate wholly-owned subsidiaries in 35 different countries throughout the world may find in each country that there are 10 independent distributors which could qualify as comparables under the temporary Section 482 regulations. In order to file its tax return under the proposed regulations without risk of penalties, the U.S. multinational would have to collect and analyze financial data from 350 independent distributors before it files its U.S. tax return and apply the results of that analysis to its own financial results. In many instances, the third party information may not even be available by the time the tax return is due. Furthermore, the duplicative administrative burden on U.S. multinationals suggested by these proposed regulations is enormous. Consider the situation where a second U.S. multinational is also distributing a similar product in the same foreign countries as the first U.S. multinational. It also will have to separately collect and analyze the same information from the 350 independent distributors as the first U.S. multinational by the time it files its U.S. tax return. Multiply this simple example by the tens of thousands of products U.S. multinationals sell outside the U.S. each year and it is easy to see why U.S. multinationals are concerned about overly strenuous contemporaneous documentation requirements.

Another aspect of the proposed regulations which NFTC strongly believes should be deleted is the requirement that a taxpayer's transfer pricing methodology must be "more likely than not" to prevail in litigation to avoid a penalty. In light of the substantial amounts involved in these actions, it is unlikely that taxpayers can obtain a "more likely than not" opinion from counsel that their transfer pricing method would prevail in court no matter how much effort is expended before a tax return is filed to try to justify their transfer prices. The "reasonable belief" exception to avoid a penalty under the proposed regulations should also apply if other factors are shown to exist, i.e., reliance on prior IRS audits of methodology; reliance on a foreign tax jurisdiction's acceptance of pricing method used by the taxpayer; absence of a tax avoidance purpose and arm's length negotiations by independent divisions' etc. Many of these items were noted in submissions on Section 6662(e) before the proposed regulations were issued, but appear to have been ignored.

Further, the NFTC opposes the requirement set forth in the proposed regulations that the U.S. tax return must reflect the taxpayer's review of the arm's length requirement just before the tax return is filed and, if necessary, report income that was not earned by the U.S. taxpayer, but earned and subject to tax in the hands of a foreign affiliate. This requirement would lead to double taxation, and unlike under current procedures, there would be no opportunity to prevent double taxation through the Competent Authority process of tax treaties. At best, the Competent Authority process could seek to address double taxation which has already occurred. The U.S. cannot expect a foreign affiliate to report in its tax return less than the income earned by it, as such action could well be considered grossly inappropriate by the foreign country. Even if there is a "compensating adjustment agreement," it is not clear how many foreign countries would recognize such an agreement. Accordingly, if the requirement for self-compliance at the same time the tax return is filed remains, in lieu of reporting income earned by a foreign affiliate, the U.S. taxpayer should be able to state in its tax return that a self-compliance review indicates that the U.S. income should be increased, include a summary calculation of the increase, state that such an increase would cause double taxation, and state that the U.S. taxpayer will file a Competent Authority Request within 90 days of filing the tax return. If such a Request is not filed, the IRS would have the automatic right to increase the income in accordance with the calculations provided.

An additional potential concern of NFTC is the Administration's proposal to bolster and expand the number of IRS agents employed to

audit transfer pricing of foreign companies doing business in the U.S. NFTC is concerned that foreign governments will begin to object that their taxpayers are being treated in a discriminatory manner in this area by the U.S. in violation of U.S. treaty obligations. It can be expected that foreign governments will eventually retaliate against U.S. companies operating within their borders. The NFTC is concerned that this scenario would inure to the detriment of the U.S. companies operating abroad and to the global economy in general. In fact, it is for this reason that the NFTC believes from a broader international tax policy perspective that Section 6662(e) should be significantly limited in scope to apply to only offensive taxpayer behavior.

III. **Require Current Taxation of Certain Earnings of Controlled Foreign Corporations**. The NFTC opposes the proposal to require 10 percent U.S. shareholders of certain controlled foreign corporations (CFCs) to include currently in income the prorata share of income (above a threshold) from so-called passive assets to the extent of accumulated earnings and profits.

Existing Code provisions provide adequate safeguards against revenue losses attributable to the retention of earnings abroad to avoid U.S. tax. The proposal would add substantial complexity to an existing set of rules that are already difficult to comply with, due to a lack of clarity. Furthermore, there has been a tendency in recent years to erode incrementally the concept of not taxing the active earnings of foreign subsidiaries until they are repatriated to the U.S. In particular, the Administration Plan unwisely proposes to reclassify certain active business earnings as passive income in two different provisions: the proposed allocation of active royalty income to the passive limitation foreign tax credit basket and the proposal to move income from working capital in the oil and gas industry also to the passive limitation basket.

IV. **Expansion of Earnings Stripping Rules.** The NFTC objects to the proposed expansion of the earnings stripping rules. The legislation would build upon a flawed regime of imposing thin capitalization requirements on foreign corporations alone, which is discriminatory on its face. Of equal concern, the proposal addresses no new perceived abuses in the financing of U.S. subsidiaries of foreign parent companies through the use of parent guarantees; instead, the Treasury has admitted that it is unable to differentiate between abusive and nonabusive guarantees and thus decided to penalize all foreign companies with U.S. subsidiaries that borrow with the parent's guarantee.

The proposal is also flawed because there is no tax abuse where a U.S. subsidiary borrows with a parent's guarantee from a lender subject to U.S. tax. The interest rate charged (and the interest deduction claimed) will be lower, reflecting the parent's credit rating. On the other side, the income will be fully taxed to the lender. Unlike intracorporate borrowings, there is no possibility that the income will escape tax when paid to the foreign parent while the U.S. subsidiary claims an interest deduction.

If Congress is to legislate in this admittedly difficult area, then one alternative is to require the taxpayer to prove the following three facts: first, that the debt is held by an unrelated third party; second, that the subsidiary could have borrowed the sums involved without the guarantee; and third, that the interest rate charged the borrower is not substantially above that available to the parent company. Although subjective, this alternative would permit taxpayers to make a showing of non-abuse in guaranteed borrowing cases. In addition, the provision should apply only to guarantees that are enforceable by the lender against the guarantor as to principal and interest.

In any event, the provision must apply only to borrowings that occur after the date of enactment. Otherwise, a very large number of existing commercial borrowings and debt offerings will be thrown into question, jeopardizing the credit markets. Moreover, at the time of enactment of the original earning stripping rules, there was a Congressional commitment that any tightening of the guarantee rules would not apply to borrowings outstanding at the time tightening was announced.

PROPOSALS OF GENERAL INTEREST

Corporate Rate Increase. The NFTC opposes the proposed increase in the maximum corporate rate from 34 to 36 percent. The NFTC notes with approval that the Tax Reform Act of 1986, which lowered the maximum rate of tax on corporate income from 46 to 34 percent, almost singlehandedly led to a worldwide reduction in corporate tax rates. It is this historical fact that causes the NFTC concern that a corporate rate increase in the U.S. will be quickly followed by the adoption of similar rate increases by our trading partners. If this scenario materializes, the likely consequence would be to retard global economic growth.

Temporary Incremental Investment Tax Credit. The NFTC would recommend that the proposed temporary incremental investment tax credit be dropped from the Administration Plan. While the rationale behind the proposal is a good one, namely, providing an incentive for the immediate purchase of plant and equipment, the proposal unfairly penalizes companies that have recently invested in modernizing their plant and equipment. The NFTC continues to be of the view that a maximum corporate rate of 34 percent is preferable to the proposed temporary ITC. Alternatively, we would recommend that revenue derived from deleting the temporary ITC be applied to eliminate or modify the international tax provisions in the Administration Plan.

Modification of Alternative Minimum Tax Depreciation Schedule. The NFTC strongly supports the elimination of the adjusted current earnings (ACE) adjustment to the corporate alternative minimum tax. Deleting the ACE adjustment provides simplification because it reduces the number of separate sets of books that must be maintained. The NFTC also supports adjustment of the AMT depreciation schedule that would compute depreciation using a 120 percent declining balance depreciation method. The NFTC prefers the approach in the Clinton Plan to the provision in H.R. 4210 and H.R. 11, due to the shorter recovery period provided for depreciable property. However, we note that some NFTC member companies prefer the proposal in the Administration Plan, because the Administration proposal does not assign a recovery period shorter than those provided in H.R. 4210 or H.R. 11 for all categories of property.

The NFTC believes that these proposed changes deserve widespread support. They will eliminate or at least mitigate the onerous result under present law, in which many capital intensive companies incur a sizable alternative minimum tax liability even though they are experiencing heavy economic losses. NFTC does not believe that the corporate AMT was designed to produce such a harsh result.

Energy Tax. Although the NFTC understands that the rationale behind the energy tax is both revenue driven and is designed to curb environmental pollution, we are concerned that the tax will have a disproportionate adverse impact on energy-producing companies and on businesses that are heavy energy consumers. Moreover, the tax in its present form favors certain energy sources and discriminates against others in a manner that reflects political considerations more than environmental concerns which we believe is undesirable. The NFTC believes that any industrial segment consumption tax should be border adjustable in order to encourage exports and to avoid favoring imported goods. The issues of computation and collection of the tax should also be satisfactorily resolved in a

manner that does not disrupt normal business activities with unduly burdensome administrative requirements.

Section 936 Possessions Credit. NFTC believes that the proposal to limit the Section 936 credit to 65 percent of the wages that a possession's corporation pays to its employees would severely limit the utility of the credit. Due to the heavy reliance that Puerto Rico and other possessions place on the Section 936 credit to attract investment and to stimulate business activity, the NFTC believes that it would be advisable to defer consideration of the proposal until the potential effects of its adoption can be fully evaluated. If it is determined that the Section 936 credit should be repealed, then a lengthy transition period should be provided to cushion the impact on Puerto Rico and other possessions.

Mr. KOPETSKI. I thank you for your concise and informative statement.

We are going to have to recess for 7 minutes, so I hope you can just stick around. The committee is recessed for 7 minutes.

[Recess.]

Mr. KOPETSKI. The committee will return to order.

Our next witness is Thomas Bretz, national director, international tax policy, Price Waterhouse.

Welcome.

STATEMENT OF THOMAS R. BRETZ, NATIONAL DIRECTOR, INTERNATIONAL TAX POLICY, PRICE WATERHOUSE, ON BEHALF OF THE ROYALTY COALITION

Mr. BRETZ. Thank you.

Mr. Chairman and members of the committee, I am Tom Bretz, a partner with Price Waterhouse. I am here today on behalf of a broad-based coalition of companies who support retaining the current law treatment of foreign royalties. The companies in our coalition reflect the trend to global markets.

In 1992, they had worldwide sales of $250 billion, 41 percent by foreign operations. They employed 740,000 people in the United States, 10 percent in research-related activities. They spent $11 billion on R&D in the United States. These investments in the United States help maintain the Nation's competitive edge and generate high-quality jobs.

Every company I am representing today supports the broad policy goals and objectives of the President's economic plan. However, we believe the proposal to change the treatment of foreign royalties is inconsistent with the goals of the plan and will harm the competitive position of U.S. companies selling their products abroad.

The administration has proposed treating active foreign royalties as passive, on the basis that active treatment can result in a tax preference for licensing intangibles abroad. The implications are that the royalty proposal will encourage increased production at home, lead to U.S. job creation at the expense of foreign jobs, and that foreign markets would be maintained through exports. I cannot emphasize strongly enough how far these stray from reality.

It is business necessity, not tax preferences, that causes U.S. companies to license intangibles abroad, for a number of business reasons. Some are as basic as local content requirements that necessitate a portion of the products sold in a foreign country be produced in that country. For many industries, it is simply not feasible to supply foreign markets by export alone.

For many consumer goods, particularly food products, it simply would not be practical to ship the products abroad, due to spoilage and other factors. The cost of shipping products is high, making it difficult for U.S. companies to compete with foreign companies producing those products locally. And global competition cannot be ignored in formulating the Nation's tax policy. As these examples make clear, it has become increasingly obvious that relying on exports alone to penetrate foreign markets is not the right strategy.

Recent studies confirm that increased foreign business activity enhances the level of U.S. employment and economic growth, and

that sales by foreign affiliates of U.S. based MNC's come at the expense of foreign competitors, rather than U.S. exporters.

Available tax data also suggest that U.S. MNC's are not operating abroad to take advantage of U.S. tax incentives. Recent statistics show that the effective rate on foreign income is higher than on U.S. income. Imposing new taxes on the foreign income of U.S. companies is not in the long-run interest of the Nation or its workers.

What would the real impact of the royalties proposal be, if it were to become law? The companies in our coalition feel very strongly that in some cases the provision would encourage the exportation of R&D activity and related jobs to foreign countries, and encourage increased foreign investment at the expense of investment in the United States.

Aside from its adverse impact on U.S. employment and international competitiveness, the royalty proposal is inappropriate as a matter of tax policy. The current foreign tax credit rules treat active foreign income differently than passive income. The royalty proposal would carve out one slice of active income and treat it as though passive. Developed intangible assets, such as patents, know-how and trademarks used in a business, are as active in nature as tangible assets, such as a manufacturing facility.

In conclusion, Mr. Chairman, the administration's broad policy goals have merit and should be pursued. The foreign royalty proposal, however, would encourage the exportation of R&D activity, encourage increased foreign investment at the expense of U.S. investment, and it ignores the business necessities that require U.S. multinationals to manufacture products in the market where they will be sold, for competitive reasons.

For these reasons, we urge the administration and the committee to reconsider the royalty proposal.

Thank you.

[The prepared statement follows:]

TESTIMONY OF THOMAS R. BRETZ
Royalty Coalition

I. INTRODUCTION

I am Thomas R. Bretz, the National Director of International Tax Policy for Price Waterhouse, and I am testifying today on behalf of a broad-based coalition of companies formed to advocate the retention of current-law tax treatment of foreign-source royalties received by U.S. companies.

Reflecting the trend to global markets, the companies in our coalition relied on foreign operations for 41 percent of worldwide gross receipts, totalling over $250 billion in 1992. These companies invest billions of dollars in the United States developing valuable assets -- such as know-how, patents, trademarks -- that must be utilized in markets around the world to recoup the cost of development. The investments we make in the United States help maintain the nation's competitive edge and generate high quality jobs. Coalition companies employ 740,000 people in the United States, including 74,000 in research-related activities (89 percent of worldwide R&D employees) and spent almost $11 billion domestically on research and development.

Our companies face formidable competition from foreign-based multinational corporations in both the U.S. and foreign markets. Make no mistake, competition in global markets is fierce -- the companies in our coalition had fewer employees last year, both in the United States and abroad, than they did 10 years ago. Our long-term survival requires global operations designed to maximize economies of scale and economic efficiency. By competing globally for market share, we preserve high-quality jobs in our U.S. headquarters. Moreover, foreign affiliates are crucial to U.S. exports -- in 1992, over 60 percent of our exports were sold by our foreign affiliates.

Every company I am representing today supports the broad policy goals and objectives of the President's economic plan, namely to build an environment for economic growth focusing on the creation of new jobs, long-term economic investment, and reducing the federal budget deficit. However, we believe that the specific proposal to change the tax treatment of foreign source royalties is inconsistent with these economic goals for the following reasons:

- The royalty proposal would reduce domestic R&D and could provide an incentive for U.S.-based multinational corporations to move R&D and other jobs overseas. Royalties from the license of intangible property to overseas users is an important source of well-paying U.S. jobs in the area of R&D, marketing, management, information systems, and other administrative areas that support the development of intangible property.

- Business and competitive circumstances often dictate that U.S.-based MNCs perform significant activities abroad involving the use of intangible assets (such as manufacturing, distribution, and technical support) in order to penetrate and survive in foreign markets; it would be counterproductive for U.S. international tax policy to discourage such activities.

- According to the General Accounting Office, the foreign income of U.S.-based multinationals is already more highly-taxed than U.S. income. The royalty proposal would increase the over-taxation of foreign income of U.S.-based MNCs.

II. THE ADMINISTRATION'S ROYALTY PROPOSAL

The Administration has proposed including all foreign source royalty income in the separate foreign tax credit limitation category for passive income (i.e., the "passive basket"). This would have the effect of significantly increasing the effective tax burden on foreign income of U.S.-based MNCs.

Treasury's Greenbook[1] provides the following rationale for the royalty proposal:

> The treatment of substantial portions of foreign source royalty income as general limitation income for foreign tax credit limitation purposes...can result in a tax preference for licensing of intangible property to a foreign person for use in production activities abroad.... In contrast, royalties or other income received for the use of intangible property in domestic activities generally cannot be similarly sheltered. (Emphasis added).

The implication is that the royalty proposal will encourage expanded use of intangible property in domestic activities (instead of foreign activities), thus leading to U.S. job creation and growth at the expense of foreign job creation and growth.

On the surface, this reasoning has appeal. Indeed, other factors being equal, we agree that the U.S. tax system should not promote foreign-based activity at the expense of U.S.-based activity. However, on closer analysis, the royalty proposal could produce results at odds with the Administration's broad policy goals, for the reasons set forth below.

III. FOREIGN ACTIVE BUSINESS OPERATIONS ENHANCE U.S. JOBS AND U.S. ECONOMIC GROWTH

Three decades ago, U.S. corporations accounted for over half of all multinational investment in the world, our nation produced about 40 percent of world output, and we were the world's largest lender of capital. Because the U.S. economy was so dominant, tax policy makers felt little need to analyze how the U.S. system for taxing foreign income affected the competitiveness of U.S. companies in world markets.

Today, the U.S. economy is no longer so dominant that global competition can be ignored in formulating the nation's tax policy. In the new international economic environment, Europe and the Pacific Rim rival North America as regional superpowers. The single European Community (EC) market and the conversion of the Eastern European economies from centrally-planned to market-oriented economies will further expand European influence.

U. S. corporations now account for less than one-third of multinational investment, the U.S. economy produces less than 30 percent of world output, and we are the world's largest debtor. Three decades ago, 18 of the 20 largest corporations in the world were headquartered in the United States; today, only nine U.S. corporations rank in the top 20.

Arguments that we must discourage U.S. investment abroad to protect domestic employment are obsolete in the new international economic environment. In an increasingly open economy, discouraging U.S. companies from producing in the most efficient locations will not protect U.S. jobs; instead, these jobs will go to foreign-based multinationals with lower costs. Indeed, the evidence suggests that multinational investment promotes exports: two-thirds of U.S. merchandise exports were associated with U.S. multinationals; and the industries that are most active overseas tend to be the same industries that are the most effective exporters. In short, global investment strategies are critical to the competitiveness of the U.S. economy.

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[1] See "Summary of the Administration's Revenue Proposals" (Department of the Treasury, February, 1993), at page 58.

Thus, any proposal designed to prevent U.S. companies from operating internationally would be counter-productive to the Administration's broad policy goals. Recent studies confirm that increased foreign business activity enhances the level of U.S. employment and overall U.S. economic growth; and that sales by foreign affiliates of U.S.-based MNCs come at the expense of foreign competitors rather than U.S. exporters.

As noted by Harvard Business School professor Michael Porter in *The Competitive Advantage of Nations*

> Some observers see firms becoming competitive at the expense of their nation when they source parts, manufacture, or develop products abroad. Policies by a nation to prevent its firms from manufacturing or sourcing offshore, though tempting, are self-defeating. Blocking such actions will only undermine the ability to sustain advantage in an industry. The only real solution is to alter national circumstances so that firms will choose to do more at home.

In an increasingly global economy, U.S.-based MNCs are vital to the health of the domestic economy. Exports by U.S.-based MNCs accounted on average for almost two-thirds of total U.S. manufactured exports in 1989 and in 1990. In 1990, U.S.-based MNC's merchandise trade exports exceeded imports by $34 billion, in sharp contrast to the nation's overall $102 billion merchandise trade deficit.[2]

Some have argued that overseas investment by U.S. multinationals represents a drain on investment at home. Yet, over the last decade, foreign income has exceeded foreign investment in U.S.-owned foreign corporations. Thus, the growth in U.S. direct investment abroad has been financed internally and not by outflows of capital from the United States.

IV. BUSINESS PRACTICES AND NECESSITIES DICTATE FOREIGN ACTIVITY

Many U.S.-based MNCs derive active foreign income purely because business considerations, rather than tax motivations, require the use of U.S.-developed intangibles[3] in geographic proximity to foreign markets.

U.S. companies license intangibles abroad for a multitude of business reasons. Some are as basic as local-content requirements that necessitate that at least a portion of such products sold in a foreign country be produced in that country. Thus, royalties often support and promote exports of U.S. manufactured goods.

For example, U.S. exporters of heavy equipment, such as power generation equipment and locomotives, are often forced by their customers to engage local suppliers for the low-value added portion of a particular product in order to meet local content preferences or requirements of purchasers. To meet this request for local

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[2] US Department of Commerce, "Survey of Current Business," August 1992, December 1992.

[3] Current U.S. tax rules (see Code sections 482 and 367(d), discussed infra) effectively require a U.S.-based MNC to make its intangibles available to foreign affiliates by a license requiring royalties reflective of the ongoing value of the intangible. Failure to comply with these and related rules can result in the imposition of substantial penalties. Additionally, as discussed, infra, the "look-through" rules of Code section 904(d)(3) encourage royalty and other deductible payments to reduce foreign income taxes.

content, the local suppliers need access to the U.S. manufacturer's specifications and technical expertise. These suppliers, sometimes referred to as manufacturing associates, pay substantial royalties for access to the U.S. exporter's technical information which enhances the exporter's return. Such royalties, of course, are a critical part of the overall economic return in what is fundamentally an export activity. Without the requisite local content, the export order often would not be obtained. The license in this case is not a vehicle for giving technology to a foreign producer. Rather, the license preserves the technology and controls its use so that the U.S. producer can protect its technology for future exports.

For many industries, it simply is not feasible to supply foreign markets by export alone. The unit cost of shipping many of the products produced by companies in our coalition is extremely high. The added costs of transporting such products across oceans -- including the shipping costs, foreign duties, and other expenses -- would make it impossible for U.S. companies to compete with foreign companies producing those products locally. For many consumer goods, particularly food products, it would, simply not be practical to ship products abroad, due to spoilage and other factors.

Foreign licensing also is required where, for example, FDA regulations preclude the manufacture and export of drugs that have not been approved in the United States.

In addition, many foreign jurisdictions continue to discriminate in favor of local manufacturers in terms of granting early product approvals and favorable in-market pricing. There can be significant duty advantages to supplying products destined for the EC from a European location.

Maintaining an EC manufacturing presence also permits the exercise of EC patent rights and, thus, avoids possible compulsory licensing.[4]

Finally, there are instances where a company will license it's products to a third-party abroad in order to gain access to that party's products (i.e., cross-licensing arrangements) or to otherwise establish a business relationship with that party.

Statistics Show Foreign Income Bears Higher Tax Burden Than U.S. Income

Available data suggests that U.S.-based MNCs are not operating abroad to take advantage of U.S. tax incentives; indeed, current law provides an overall disincentive for U.S. companies to operate abroad.

According to statistics released recently by the General Accounting Office (GAO), worldwide tax as a percentage of worldwide income of U.S.-based MNC's (37.1 percent) far exceeded U.S. tax as a percentage of U.S. income (32.9 percent) for accounting periods

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[4] In many less developed countries, maintenance of foreign-owned patents requires proof of actual production or exploitation of the patented subject matter within those countries. For the most part, these patent "working" requirements can not be met simply by exporting finished products from another country. Failure to meet these requirements may subject the U.S. company to sanctions or otherwise put the company's operations in that country into jeopardy.

ending in 1989.[5] This data demonstrates that, while aggregate U.S. income is subject to an effective tax rate less than the U.S. statutory rate, foreign income is subjected to a rate in excess of the U.S. statutory rate. Thus, foreign income of U.S.-based MNCs is subject to a higher level of taxation than U.S. income.

In a recent study, Price Waterhouse compared the effective tax rate (including both home and host country national income taxes) that results when the same cross-border operations are conducted by a multinational headquartered in the United States and six other major industrial countries. The study found that a U.S. multinational -- manufacturing in Italy and selling into Europe through a Swiss sales subsidiary -- would pay an effective tax rate of 35.2 percent as compared to an average effective tax rate of 29.2 percent if the European operation had been owned by a Canadian, French, German, Japanese, Dutch, or British parent. The higher effective tax rate for the U.S. multinational -- ranging from four percentage points in the case of Germany to 10 percentage points in France -- is tantamount to a surtax that foreign-based multinationals do not bear.

This higher overall tax burden borne by U.S. multinationals on foreign income as compared to U.S. income is explained in large part by the bias in our current tax system in favor of over-taxing foreign income. The roots of this are found in a number of areas. For example, the current rules mandating the allocation of interest expense[6] and state income taxes[7] against foreign income frequently result in the imposition of "residual" U.S. tax on foreign income that has already borne foreign income tax at a rate higher than the U.S. statutory rate.

V. THE ROYALTY PROPOSAL WOULD INHIBIT U.S. EMPLOYMENT AND ECONOMIC GROWTH

The proposal would discourage research and development (R&D) activity in the United States and, in some cases, encourage shifting research and investment outside of the United States.

The royalty proposal would discourage the licensing of U.S.-developed intangibles to foreign licensors. U.S. companies with excess foreign tax credits would have little choice but to seriously consider increasing the development of intangibles overseas in countries where intangibles-related income is taxed

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[5] US General Accounting Office, *1988 and 1989 Company Effective Tax Rates Higher than in Prior Years*, August 1992, GAO/GGD-92-111. Foreign tax as a percentage of foreign income is higher than worldwide tax on worldwide income (37.1 percent) because this percentage is a weighted average of U.S. tax as a percentage of U.S. income (32.9 percent) and foreign tax as a percentage of foreign income.

[6] Under section 864(e) of the Code, interest incurred by a US consolidated group (including financing subsidiaries engaged in unrelated businesses) is allocated to all of the income -- domestic and foreign -- of the group, including income from foreign subsidiaries. However, interest expense of a foreign subsidiary, in effect, is allocated only to its own income. This results in the over-allocation of U.S. incurred interest expense to foreign source income, thus inappropriately reducing the foreign tax credit.

[7] The regulations require that state income taxes be allocated to, foreign income. This reduces the foreign tax credit, notwithstanding that state income taxes do not relate legally or conceptually to the generation of foreign income. Moreover, no foreign government allows a deduction for income taxes paid to any state.

more favorably than in the United States.[8] This would entail the removal of R&D activity and related jobs to foreign countries. This would be especially likely for those U.S.-based MNCs that frequently are in an excess foreign tax credit position (due, for example, to the over-allocation of U.S. interest expense to foreign income) and which for business reasons are required to conduct active business operations involving the use of intangibles in foreign markets.

The royalty proposal would further erode the ability of U.S.-based MNCs to compete against foreign multinationals in overseas markets.

As noted above, foreign income is more heavily taxed than U.S. income. Adoption of the royalty proposal would increase the level of over-taxation. The net result would be a further erosion of the ability of U.S.-based multinationals to compete in foreign markets against foreign-based multinationals that do not shoulder a similar home-country tax burden.

VI. THE PROPOSAL REPRESENTS UNSOUND TAX POLICY

Aside from its adverse impact on U.S. employment and international competitiveness, the royalty proposal does not advance the state of international tax policy.

The current foreign tax credit limitation provisions are far more complex and restrictive than those of other countries. However, a mitigating feature is that active business income is generally included in the overall or "general" basket. Moreover, items of non-movable active income derived from the <u>same</u> business are almost never subject to separate limitations. The look-through rules of section 904(d)(3) of the Code generally ensure this result for royalties paid between members of a U.S. group by "basketing" these royalty payments with reference to the underlying earnings out of which these royalties are paid.

The royalty proposal would carve out one slice of active income generated from an integrated business activity for separate treatment. Developed intangible assets (for example, patents, know-how, and trademarks) used by members of an affiliated group engaged in an active integrated business are as "active" in nature as tangible assets (for example, a manufacturing facility) used in the active integrated business; both categories of assets generate active income. This "active" characterization is equally applicable regardless of where in the group (<u>i.e.</u>, in which entity and in which geographic location) the asset is employed, and regardless of the characterization of the income derived from the use of the intangible in the business (<u>e.g.</u>, sales income, royalty or rental income).

The proposal to carve out a slice of active income and tax it as passive income is inappropriate as a matter of tax policy for the following reasons:

<u>Active vs. Passive Income</u>

Under the Administration's proposal, foreign income taxes paid on a slice of active foreign income could not be credited against tax on the active income derived from the same integrated business. This would amount to a schedular approach to taxing active income. Some may argue that this approach is appropriate because current law permits "averaging," which should be curtailed. However, this argument ignores "the integrated nature of U.S. multinational

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[8] Ownership of the intangibles developed through these offshore R&D activities would then rest with the foreign affiliate(s), thus eliminating the requirement to make royalty payments into the United States.

operations abroad"[9] as recognized in 1986 by Congress when it created the current treatment of royalties. Thus, Congress validated the notion that the foreign income taxes paid on the active income of the business relate conceptually to all of the active income from the business derived by the U.S. parent. Moreover, Congress believed that "averaging" only would be inappropriate "when it would distort the purpose of the foreign tax credit."[10]

Branch vs. Controlled Foreign Corporation (CFC)

In many instances, the royalty proposal would have the effect of imposing a higher effective U.S. tax rate on income from an active business operated in corporate rather than branch form. Under current law, the inclusion of royalty and other types of income received from CFCs in the overall basket is intended to equate the U.S. tax treatment of CFCs with foreign branches. The Report of the Senate Finance Committee to the 1986 Tax Reform Act (Senate Report) states:

> The look-through rules are intended to reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (or through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation or other related person.[11]

U.S. international tax policy has recognized the merits of treating branches on a par with CFCs, and vice-versa. The royalty proposal would undercut the ability of many U.S.-based MNCs to operate abroad through CFCs even though the operational needs of the foreign business may weigh in favor of corporate, rather than branch form.

Preserving branch-CFC equivalence should continue to be an objective of U.S. international tax policy. Tipping the scales in favor of branch form would penalize those U.S.-based MNCs which, for valid and often compelling non-tax business reasons, operate abroad through CFCs.

Discourages Foreign-Tax Deductible Repatriations

The effect of the royalty proposal runs counter to a fundamental U.S. tax policy goal of encouraging companies considering ways to reduce their overall tax burden to first seek methods for reducing foreign taxes. In this regard, the Senate Report states:

> The committee bill subjects interest, rents, and royalties to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a controlled foreign corporation, or other related person. In addition, the committee believes that such interest, rents, and royalties should be treated for separate limitation purposes like dividends eligible for a deemed-paid foreign tax credit ... so that payment of the former will not be discouraged. Interest, rents, and royalties generally are deductible in computing tax liability under foreign countries' tax laws while dividend payments generally are not; thus, in the aggregate, interest, rent, and royalty

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[9] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, May 7, 1987, (the "1986 Bluebook") at 862.

[10] Ibid.

[11] S. Rept. No. 99-313, 99th Cong., 2d Sess. 314 (1986). See also the 1986 Bluebook at 866.

payments reduce foreign taxes of U.S. owned foreign corporations more than dividend payments do. Under the foreign tax credit system, the payment of interest, rents, and royalties by controlled foreign corporations and other related foreign corporations whose dividends carry a deemed-paid credit may, therefore, reserve for the United States more of the pre-credit U.S. tax on these U.S.-owned corporations' foreign earnings than the payment of dividends.[12]

Increase in Royalty Payments to U.S. Parents Since 1984 is Consistent with Congressional Intent -- Not an Abuse

Some have argued that the rapid rise in net royalties received from foreign affiliates by U.S. parents, from $4.1 billion in 1985 (1.8 percent of foreign direct investment) to $12.6 billion in 1991 (2.8 percent of foreign direct investment), is indicative of a "tax abuse" which merits adoption of the Administration's royalty proposal.

This view ignores Congressional intent as indicated by the legislative history of the changes made to section 367(d) in 1984 and to section 482 in 1986. In fact, section 367(d) was designed to ensure that royalties would be paid for the use of U.S.-developed intangibles by foreign affiliates, instead of transferred, without consideration, as a contribution to capital:

> In response to the substantial tax advantages available to taxpayers if they could transfer intangibles ... without the payment of any royalty ..., Congress amended section 367(d) in 1984 to provide that ... a transfer of intangibles to a foreign corporation ... would be treated as a sale of the intangibles ... amounts included in income of the transferor on such a transfer must reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use or disposition of the property.[13]

In 1986, Congress amended section 482 to increase the amount of royalties paid with respect to the transfer of intangibles in cases where these royalties were deemed to be inadequate. In the legislative history of the 1986 Act, the Joint Committee on Taxation stated:

> Congress was concerned that the provisions of sections 482, 367(d), and 936 ... may not have been operating to assure adequate allocations to the U.S. taxable entity of income attributable to the intangible in these situations.[14]

As a result of the changes to sections 367(d) and 482 in 1984 and 1986, respectively, it is not surprising that royalty payments from foreign affiliates increased more rapidly than foreign direct investment after 1984. Rather than a "tax abuse," this result is precisely what Congress intended.

The growth in international joint ventures in recent years also may have contributed to the rise in royalty payments. Increasingly, U.S. companies joint venture with foreign partners to gain access to foreign markets. In these arrangements, the U.S. partner frequently contributes valuable intangibles while the foreign partner contributes financing as well as manufacturing and

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[12] Ibid.

[13] The 1986 Bluebook at 1012.

[14] Ibid. at 1014.

distribution capabilities. Such joint ventures have provided U.S. companies with a wider range of options for maximizing the value of their intangible assets in foreign markets. It should be noted that the growing use of international joint ventures has occurred in spite of formidable tax disadvantages for U.S. companies participating in such ventures.[15]

VII. **SUMMARY**

We support the Administration's broad policy goals to build an environment for long-term economic growth. The royalty proposal runs counter to these goals because it threatens the competitiveness of U.S.-based MNCs and U.S. jobs.

The royalty proposal would discourage domestic research and development activity. This would mean less investment in the United States. The royalty proposal would further erode the ability of U.S.-based MNCs to compete against foreign-based MNCs in overseas markets. For these reasons, as well as the tax policy reasons stated above, we urge the Administration and the Committee to reconsider the royalty proposal.

Coalition Member Companies

General Electric Co.
Goodyear Tire & Rubber Company
Harnischfeger Industries
IBM Corporation
Kellogg Company
Levi Strauss & Co.
Merck & Co., Inc.
Procter & Gamble
Philip Morris Companies, Inc.
Premark International, Inc.
Sara Lee Corporation
Scott Paper Company
Xerox Corporation

[15] Robert J. Patrick, "A Review of U.S. Tax Laws Applicable to Cooperative International Business Ventures," Tax Notes International, (March 1990).

Mr. KOPETSKI. Thank you, Mr. Bretz.

We will now hear from Dexter Baker, chairman, executive committee, board of directors, Air Products & Chemicals, Inc., Allentown, Pa.

Welcome.

STATEMENT OF DEXTER F. BAKER, CHAIRMAN, EXECUTIVE COMMITTEE, BOARD OF DIRECTORS, AIR PRODUCTS & CHEMICALS, INC., ALLENTOWN, PA, ON BEHALF OF THE COMMITTEE ON ROYALTY TAXATION

Mr. BAKER. Thank you, Mr. Chairman.

You have it exactly right, I was until May of last year, however, chairman and chief executive officer of Air Products, and in the intervening 12 months served as chairman of the National Association of Manufacturers.

I am here today on behalf of the Committee on Royalty Taxation, regarding President Clinton's proposals to treat all foreign-source royalty income as passive income, rather than active income.

Incidentally, I am authorized to testify that I do represent the views of the 12,000 members of NAM, which constitute about 80 percent of all manufacturing output here in the United States.

The Committee on Royalty Taxation, referred to as CORT, is a broad-based coalition of 14 U.S. multinational corporations. We operate in various businesses, including industrial gases, information technology and services, consumer products, food, electronics, chemical, construction, building products, restaurants, and the aerospace industry.

The members of CORT each derive significant revenues from foreign-source royalty income earned in the conduct of their active businesses. The members of CORT would be adversely affected by President Clinton's proposal on royalty taxation.

CORT believes that the royalty tax proposal runs directly counter to the administration's stated goals of reducing the deficit, encouraging U.S. based R&D, and promoting high-quality high-wage domestic jobs.

Our written statement contains detailed comments about the royalty tax proposal and several examples on how it would work to our disadvantage. Let me just outline, however, a few of those points.

First, the royalty tax would treat all foreign-source royalty income earned by U.S. companies in the conduct of their active business as passive income, and that makes no practical sense. Active royalty income is simply a part of the income stream generated from the conduct of active businesses.

In the case of my company, Air Products, it earns active royalty income by licensing self-developed technology which it instructs its foreign subsidiaries to use in the design and manufacture of industrial gas plants. The technology is also used in the development of new markets for those products from those plants.

Active royalty income earned by Air Products and other members of CORT possesses no special characteristics which render it less active than other business income. CORT strongly believes that it is unsound tax policy to attempt to separate active royalties from other active income streams.

Second, it has been suggested that the royalty tax proposals can be justified as a runaway plant measure. Let me respond by again referring to my company. Air Products does not operate offshore because of the treatment accorded to royalties under present law. Air Products cannot supply the foreign market for industrial gases from the United States. We must build plants close to our customers.

It is uneconomical to transport industrial gases from the United States to overseas. Our overseas operations clearly cannot be deemed runaway plants. Rather, they generate considerable extra income, exports from the United States, dividend flows back to the United States, royalty flows back to the United States, as well as high-quality, high-paying jobs in the United States in our manufacturing and research establishments. Other members of CORT have exactly the same results from their activities.

Two members of CORT estimate that had the proposed royalty tax been in place for 1992, it would have increased their effective tax rate on foreign source income by as many as 20 percentage points. Obviously, a rate increase of this magnitude goes well beyond what is deemed to be prudent.

The royalty tax proposal would reduce the aftertax rate of return on U.S. R&D investments and would tend to lead to a reduction in the level of U.S. R&D activity and high-quality jobs in this country.

Simply stated, the proposal would make the United States less competitive in keeping R&D activities in the United States. By increasing the effective tax rate on repatriated dividends, the royalty tax will encourage retention of earnings and foreign reinvestment of those earnings by our foreign subsidiaries. I know this from personal experience. It is Air Products' technology that made it possible for us to gather almost 50 percent of the British industrial gas markets in a period of 36 years.

Mr. Chairman, the royalty tax proposal represents an unwarranted and shortsighted reversal of existing laws, and I hope your committee will not approve the current recommendations.

Thank you.

[The prepared statement and attachment follow:]

Statement of Committee on Royalty Taxation ("CORT")

on

President Clinton's Proposals for Public Investment and Deficit Reduction

Submitted to

Committee on Ways and Means
U.S. House of Representatives

April 1, 1993

Mr. Chairman and Members of the Committee: My name is Dexter F. Baker. I am Chairman of the Executive Committee of the Board of Directors of Air Products and Chemicals Incorporated. Until May 1992, I was Chairman of the Board and Chief Executive Officer of Air Products. I am pleased to testify on behalf of the Committee on Royalty Taxation ("CORT") regarding President Clinton's proposal to treat all foreign source royalty income as passive income for foreign tax credit purposes. I have also recently completed a year as Chairman of the National Association of Manufacturers ("NAM") and am authorized to state that this testimony is supported by the 12,000 members of the NAM.

Background.

The Committee on Royalty Taxation ("CORT") is a broad-based coalition of 14 U.S. multinational companies engaged in various businesses including the industrial gas, information technology and services, consumer products, food, electronics, chemical, construction and building products, restaurants and aerospace industries. The members of CORT each derive significant revenues from foreign source royalty income earned in the conduct of their active businesses. The members of CORT would be adversely affected by the proposal. In fact, two members of CORT have estimated that, had the Administration's proposal been in effect for 1992, it would have increased their effective tax rates on foreign source income by as much as 20 percentage points. Obviously, a rate increase of this magnitude goes well beyond prudent action and could seriously hurt U.S. companies in their efforts to compete on a worldwide basis. CORT believes that the proposal embodies unsound tax policy and potentially would reduce U.S. based R&D, domestic jobs and investment.

Administration's Passive Royalty Proposal.

The Code provides a credit against the U.S. income tax imposed on foreign source income to the extent of foreign taxes paid on that income. To ensure that the foreign tax credit does not offset U.S. tax on U.S. source income, Section 904 of the Code prescribes a statutory limitation formula. In general, income derived in the conduct of an active business is treated as general limitation income for purposes of calculating the foreign tax credit limitation. Royalties received from unrelated parties and derived in the conduct of an active trade or business are treated as general limitation income. Royalties received from certain related parties are characterized on a "look-through" basis which results in the royalty income being treated as general limitation income provided the income of the subsidiary is earned in an active business. Other foreign source royalty income is not included in the general limitation basket, but generally is included in the separate limitation basket for passive income.

The Administration's proposal would provide for the treatment of all foreign source royalty income as income in the separate foreign tax credit limitation category for passive income.

Tax Policy Considerations.

1. **The Administration's proposal would create an artificial distinction between earnings of an integrated enterprise repatriated as royalties and earnings repatriated as dividends.**

The look-through rule of Section 904(d)(3) recognizes that earnings of a corporate group should retain the same character when repatriated to the United States, regardless of whether the earnings are repatriated as royalties, interest, dividends or otherwise. This represents sound tax policy; the character of income moving through an affiliated group should not change based on the form in which it is repatriated to the United States. As concluded by the American Law Institute:

> "[i]nterest, rents, and royalties passing from one member of an affiliated group to another have the same character; they fundamentally represent earnings and income moving through the constituent parts of an integrated enterprise." American Law Institute, International Aspects of United States Income Taxation 247 (May 14, 1986) (hereinafter "ALI Report").

Recently proposed regulations under Section 482 take the view that royalties should be considered as another way of repatriating foreign earnings from an integrated business. See Prop. Treas. Reg. § 1.482-1T(f)(2)(v) Examples 1 and 2 (royalties will not be considered blocked income if, effectively, they can be paid out in the form of dividends).

In expanding the look-through rules under Section 904(d)(3) in connection with the Tax Reform Act of 1986, this Committee recognized that interest, rents and royalties represent alternatives to dividends as a means of removing earnings from a foreign affiliate. H.R. Rep. No. 426, 99th Cong., 1st Sess. 341 (1985) (hereinafter "House Report"); see also Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 866 (1987) (hereinafter "1986 Act Bluebook"). This Committee sought to treat royalties at least as favorably as dividends so that royalty payments would not be discouraged. House Report at 341; see also 1986 Act Bluebook at 866. (Royalties, unlike dividends, generally are deductible in computing foreign tax liability and, thus, may "reserve for the United States more of the pre-credit U.S. tax on these U.S.-owned corporations' foreign earnings than the payment of dividends." House Report at 341; see also 1986 Act Bluebook at 866.)

The different treatment that would be afforded income repatriated by branches and subsidiaries of U.S. multinational companies aptly illustrates the inappropriateness of trying to split active income from a foreign subsidiary into passive and active income baskets based on the form in which it is repatriated. Branches of U.S. companies can acquire intangibles as tax-free capital contributions. Any income generated by the intangibles would constitute general limitation income. There is no policy reason to change this result merely because the branch is incorporated in a foreign jurisdiction and a royalty is paid to the U.S. parent.

2. **Existing law appropriately classifies royalties from unrelated parties as active or passive depending on whether they are an integral part of an active business.**

Existing law recognizes that royalties received from unrelated persons may be active or passive, depending on the facts and circumstances. See Treas. Reg. §§ 1.954-2T(b)(5), 1.954-2T(d) and former Treas. Reg. § 1.954A-2(d)(1)(i) and (iii). Thus, if an affiliated group develops or actively markets an intangible, the royalty income from that intangible generally will be active. The Administration's proposal would characterize all foreign source royalty income as passive without regard to the efforts of the taxpayer to generate that income as an integral part of its business.

3. **The Administration's proposal attempts artificially and unrealistically to separate the active income of an integrated business into different foreign tax credit baskets.**

U.S. multinationals, like the members of CORT, develop and license intangibles as part of their worldwide businesses. The income received from the licensing of intangibles is integrally tied to income from other operations. Active royalty income is simply a part of the income stream generated from the conduct of an active business. Air Products, for example, earns active royalty income by licensing self-developed technology which instructs its foreign subsidiaries how to design more efficient and, therefore, more competitive industrial gas plants. Active royalty income earned by Air Products and the other members of CORT is no more or less active than other business income.

The foreign tax credit has not been applied by examining the foreign tax rate on each dollar of income of an integrated business on a transactional or even on a high-tax/low-tax basis. Rather, an overall limitation generally has been deemed appropriate. In connection with the Tax Reform Act of 1986, the Joint Committee Staff reported that Congress believed, in general, that "the overall limitation was consistent with the integrated nature of U.S. multinational operations abroad." 1986 Act Bluebook at 862.

Active royalty income does not possess the characteristics which compel separate application of the foreign tax credit limitation to passive income. Separate basketing of passive income is required because taxpayers can readily choose to invest liquid funds overseas in passive investments, thereby eroding the U.S. income tax base. See House Report at 333; see also 1986 Act Bluebook at 862. Active royalty income cannot be easily generated through investment nor have its source manipulated like passive income. A taxpayer seeking active treatment for royalty income must invest its resources over a period of time to develop, market and use the royalty producing property in its active business. Moreover, royalty income is sourced where the underlying intangible asset is used. See Rev. Rul. 80-362, 1980-2 C.B. 208. Thus, once a U.S. company decides to market an intangible or a product incorporating an intangible in a given country, the source of the royalty income cannot be manipulated. See ALI Study at 342.

The only possible justification for separately basketing active royalty income is that active royalties, viewed in isolation, do bear a relatively low rate of foreign tax as compared to other active business income. Accordingly, to prevent averaging or "cross-crediting" of low-taxed active royalty income and other higher-taxed active income, separate treatment of active royalty income is necessary. This argument proves too much. Such a rationale could justify

separately basketing every income item according to its foreign tax treatment. CORT submits that "infinite basketing" of each item of active business income would be inconsistent with the global view of effective tax rates on active business income and would be a dramatic departure from the recognized notion that active income of an integrated enterprise should be treated as general limitation income.

Economic Impact of the Administration's Proposal.

1. **The Administration's proposal singles out a narrow group of U.S. multinational companies for a substantial income tax increase and would have an adverse impact on U.S. based R&D and domestic jobs.**

If enacted, the Administration's proposal would single out U.S. multinational companies that use licensing arrangements in the conduct of their active businesses for harsh tax treatment. The Administration's revenue estimate combines increased revenues from the royalty proposal with decreased revenues from the Administration's proposal to allocate 100 percent of all U.S. research and experimentation ("R&E) to the U.S.. This hides the true impact of the royalty proposal on the affected taxpayers. CORT believes that the tax increase resulting from the royalty proposal may be as great as ten times the benefit resulting from the R&E allocation rule. Moreover, many taxpayers that will be adversely affected by the royalty proposal will receive little or no benefit from the 100 percent R&E allocation rule. For example, companies which license trademarks abroad would be subjected to a tax increase as a result of the royalty proposal while receiving a de minimis benefit from the proposed R&E allocation rule.

U.S. multinational companies affected by the proposal are an important source of high-wage, high-skill domestic jobs. See Department of Commerce, U.S. Direct Investment Abroad, Preliminary 1990 Estimates at Table II.K.1 (In 1990, U.S. multinationals paid their 18.5 million employees an average wage of over $37,000.). These companies also are an important source of U.S. based research and development ("R&D") activity and the high-quality jobs this activity supports. Moreover, royalties and license fees provide a significant revenue offset to the U.S. trade deficit. E.g., Department of Commerce, Survey of Current Business 46 (December 1992). (With royalties and license fees, the 1991 U.S. trade deficit was $11.7 billion. Without royalties and license fees, the 1991 U.S. trade deficit would have been $25.5 billion.) It seems incongruous to the Administration's stated goals of reducing the deficit, promoting high quality domestic jobs and promoting U.S. based R&D to single out for a massive tax increase those corporations that provide such jobs and conduct significant levels of R&D in the United States. For example, according to Business Week, three members of CORT -- The Dow Chemical Company, Eastman Kodak Company and International Business Machines Corporation -- were among the top ten biggest research and development spenders for 1990. See Robert Buderi, et. al., The Brakes Go On In R&D, Bus. Wk., July 1, 1991 at 24, 26. The royalty tax proposal would make the United States less competitive in keeping and attracting such R&D activity.

Moreover, under the proposal, U.S. multinationals operating in foreign jurisdictions could be subject to higher effective tax rates than subsidiaries of companies headquartered in other jurisdictions. See Example 1, Appendix A.

2. U.S. multinational companies operate overseas for significant, non-tax reasons.

The Administration asserts that the royalty provision would "remove the preference for foreign licensing of intangible property." This assertion ignores the substantial, non-tax reasons why U.S. multinationals must establish overseas operations to expand into and service foreign markets. U.S. multinationals that provide certain products or services to a foreign market often must choose between producing products or providing services locally, or foregoing that market and its associated revenues entirely. With few exceptions, sales by foreign affiliates come at the expense of foreign competitors rather than U.S. exporters.

For example, Air Products, does not operate offshore because of the treatment accorded royalties under present law. Air Products cannot supply the foreign market for industrial gases from the United States. Air Products must build plants at the site of bulk gas customers engaged in continuous process industries such as electronics, steel and chemicals to provide large volumes of atmospheric gases such as oxygen or nitrogen in gaseous form. Even if the gases were liquified, the generally accepted economic delivery distance for these gases is less than 250 miles.

Other members of CORT produce certain consumer products which are impractical to ship long distances and must be produced locally. Two of the products of the Procter & Gamble Company -- disposable diapers and synthetic detergents -- illustrate this. If these products were manufactured in the United States and exported to markets in Europe and the Far East, the total delivered cost for these low-margin goods would increase an average of 20 percent. The company could not competitively price its products to recover these increased costs.

Another CORT member, Kellogg Company ("Kellogg"), must establish overseas operations to produce its ready-to-eat cereal products for foreign markets. Because cereal is a very bulky product, the overseas shipping costs would not make manufacturing in the United States economical. In addition, the quality of Kellogg's cereal would be greatly affected by the extra handling that would be involved in overseas shipments.

Information technology firms must provide substantial on-site services and support to their customers. For example, if International Business Machines Corporation ("IBM"), a CORT member, were asked to create a software applications program to streamline the banking system of a European country, IBM must learn from the customer how its banking system functions and communicate with the customer in the customer's native language. IBM personnel must be on-site to acquire such first-hand, technical understanding of the customer's business and must install the software applications program on the customer's premises. The European country would not hire IBM if IBM were unable or unwilling to work with the customer at its place of business.

Similarly, Electronic Data Systems Corporation ("EDS"), a CORT member, may enter into an agreement to manage a European regional airline's data processing needs, including its computer reservation system. Since the reservation system must be immediately and continuously available, EDS must locate the equipment and information network on the customer's premises. EDS would be unable to secure the business of the airline without its on-site presence.

Moreover, foreign direct investment is an important strategy to promote U.S. exports and U.S. jobs. For example, Dow Chemical Company ("Dow"), a CORT member, has found that after it has entered a foreign market by setting up a manufacturing facility, its exports to that foreign country go up. This is because the foreign facility purchases some of its raw materials from Dow in the United States. Also, the foreign facility enables Dow to more effectively market its entire product line to the foreign market.

3. **The Administration's proposal would represent a sharp reversal of longstanding U.S. tax policy and would force U.S. multinationals to reexamine their business practices.**

Existing law has encouraged U.S. multinational companies to increase their royalty charges to their affiliates. Indeed, as discussed above, in connection with the Tax Reform Act of 1986 this Committee determined that the payment of royalties may preserve the U.S. tax base. These companies have planned the structure of their businesses on a long term basis on the legitimate assumption as to the continuance of the existing law treatment of royalty income both from affiliates and unrelated parties. The Administration's proposal represents an unwarranted and short-sighted reversal of this policy.

The Administration's proposal would raise revenue by placing U.S. multinational companies in an excess foreign tax credit position. U.S. companies would be compelled to ameliorate the harsh tax consequences of the new regime, where practicable, through rearrangements of their business affairs. For example, to the extent the proposal reduces the worldwide after-tax rate of return on U.S. R&D investment, it could lead to a reduction in the level of U.S. R&D activity. See Example 2, Appendix A. U.S. parent companies also may tend to allow foreign subsidiaries to retain ownership of intangibles which they develop. Thus, income generated from use of the intangible in the subsidiary's business and repatriated as a dividend would be treated as active income under the look-through rules, discussed above. Moreover, the proposal would raise the effective tax rate on repatriated dividends, thereby encouraging the retention of earnings and foreign reinvestment by foreign affiliates. See Example 3, Appendix A.

U.S. companies in economically significant excess credit positions also may seek other ways to generate low-taxed, active income, such as establishing a manufacturing facility in a low-tax jurisdiction. Thus, ironically, the royalty proposal actually may create incentives for moving manufacturing facilities offshore. See Example 4, Appendix A. Some U.S. companies also may choose to conduct overseas operations through branches or enter into joint venture arrangements with their foreign subsidiaries.

After U.S. companies restructure their businesses to mitigate the effects of the proposal, it is likely that these companies will pay relatively less U.S. tax and more foreign tax. At best, achieving this result will absorb resources and time of U.S. companies better spent in active business operations. At worst, the proposal will potentially reduce U.S. based R&D, domestic jobs and investment.

<u>Certain Reported Rationales for the Administration's Proposal</u>.

1. **The Administration's proposal is not justifiable as a response to "run-away" plants.**

U.S. multinationals with royalty arrangements invest overseas to expand into and service new foreign markets, not to replace U.S. jobs. Given a choice, U.S. multinationals with royalty arrangements most often choose to produce their products in the U.S.. However, as discussed above, these companies often do not have that choice. Too often, a U.S. company seeking to break into a foreign market must choose between producing a product or providing a service locally or foregoing that market entirely. Moreover, CORT members establish overseas operations mostly in high-tax jurisdictions (Germany, France, Japan, etc.). It is CORT's understanding that the Administration has abandoned its initial efforts to paint the proposal as a response to run-away plants.

2. **The Administration's proposal cannot be justified as an offset to improperly allocated research and experimentation deductions.**

It has been suggested that the change to the treatment of active royalties is required to "recapture" deductions allocated to domestic income. This suggestion is flawed. In 1988, the Treasury, Congress and the business community concerned about the proper allocation of domestic research and experimentation (R&E) expenses reached a solution which generally allocated 64 percent of U.S. based R&E to the United States. The 64 percent allocation rule already represents the best efforts of many people over numerous years and after lengthy debate to formulate the extent that U.S. based R&E gives rise to foreign source income. Accordingly, no compensatory "recapture" of R&E deductions is required. Moreover, if the Treasury wishes to reopen the R&E allocation debate, it should do so independently of the characterization of royalty income for foreign tax credit purposes.

If it is the proposed increase from a 64 percent domestic allocation of R&E to an 100 percent domestic allocation of R&E that is cited as the justification to change the treatment of active royalties, as discussed above, the remedy is out of proportion to the incentive purportedly given.

3. **The Administration's proposal fails to address the proper sourcing of royalty income.**

It has been rumored that some Treasury officials reportedly believe that royalties should be sourced where the underlying intangibles are created, not where they are used. Such a change would represent a radical shift in U.S. international tax policy and would create havoc with our treaty partners. Rather than confronting the place-of-use rule directly, and engaging in a debate on the merits, the Treasury may have chosen to ask Congress to enact the royalty proposal. If Treasury truly believes that royalties should be sourced where the intangibles are developed, it should repeal the 30 percent withholding tax for the use of intangibles developed in other taxing jurisdictions. Since it has not proposed to do so, this rationale sounds more like an afterthought than a consistently applied view of proper tax policy.

* * *

It is antithetical to the Administration's stated economic goals to single out U.S. multinational companies with royalty arrangements for a substantial tax increase. U.S. multinational companies, like the members of CORT, are an important source of high-wage, high-skill domestic jobs -- the kinds of jobs President Clinton wants to create. U.S. multinational companies also conduct significant levels of research and development in the United States -- the kind of business activity President Clinton wants to encourage. Further, royalties and license fees derived from U.S. technology and intangible assets licensed abroad provide a significant and positive revenue offset to the U.S. trade deficit.

Conclusion.

I know from experience how important Air Products' international business is to its domestic business. I helped start Air Products' industrial gas business in England in 1957. Over the last 36 years, I have seen Air Products' share of the industrial gas market in England grow from nothing to approximately 50 percent of the market today. Increased worldwide revenues of Air Products fund more U.S. based R&D which supports high-wage, high-skill domestic jobs. The establishment of overseas industrial gas plants increases exports of Air Products' domestically manufactured equipment used in those plants. Royalty revenues repatriated to the United States support U.S. based investment and provide a positive offset to the U.S. trade deficit. Other members of CORT have similar business experiences.

Mr. Chairman, the royalty tax proposal represents an unwarranted and short-sighted reversal of existing law. Thank you for giving me this opportunity to present the view of the Committee on Royalty Taxation. At this time, I would be please to answer any questions that you may have.

The Committee's counsel is Covington & Burling. Representatives of that firm also are available to consult with your staffs. In this regard, please do not hesitate to contact Ronald A. Pearlman at (202) 662-5577 or Roderick A. DeArment at (202) 662-5900.

APPENDIX A

EXAMPLE 1

A multinational U.S. company can be competitive internationally only if it can compete both domestically and overseas. The Proposal tilts the playing field decidedly in favor of foreign competitors. This can be seen in the following example. A U.S. company has transferred an intangible worth $1,000 to a CFC operating in Country X. The CFC has other business assets worth $1,000. The CFC pays $100 in royalties to the U.S. company. The CFC has gross earnings of $200, against which it deducts the $100 royalty payment under the laws of Country X. Country X taxes royalties at 10% and corporate income at 50%. Under current law, if the U.S. company repatriates its net earnings from Country X, ($50), it will receive full credit for the $60 in foreign taxes it paid. The U.S. company will pay $68 in tax on its Country X income ($60 to Country X and $8 to the U.S.). The after-tax rate of return of the U.S. company on the assets used by the CFC is 6.6% (a net return of $132 on a $2,000 investment). Under the proposal, the U.S. company would have $16 of excess foreign tax credits and would pay $84 in tax on its Country X income ($60 to Country X and $24 to the U.S.). The after-tax rate of return of the U.S. company on the assets used by the CFC would fall to 5.8% (a net return of $116 on a $2,000 investment).

Compare the U.S. company's circumstance to a foreign company that transfers an intangible worth $1,000 to a subsidiary operating in Country X. The Country X subsidiary has other business assets worth $1,000. The Country X subsidiary pays the parent a royalty of $100 and has gross earnings of $200 against which it deducts the royalty. The foreign parent is incorporated in Country Y with a corporate tax rate of 34%. Assume the foreign parent is allowed to fully credit the $60 in taxes paid to Country X. The foreign parent will pay $68 in tax on its Country X income ($60 to Country X and $8 to Country Y). The foreign parent's after-tax rate of return on the assets used by the Country X

subsidiary is 6.6%, the same as the U.S. company under current law and well above the rate of return under the Proposal.

EXAMPLE 2

A U.S. company must decide whether to invest $1,000 in research and development in the United States. The company requires a rate of return on its investment of at least 7%. The U.S. company intends to license the intangible property it would develop from the research to an unrelated foreign company in Country X. The U.S. company also has a manufacturing operation in Country Y which earns $100 a year. Country X taxes royalties at 10% while Country Y taxes income at 50%. If the U.S. company repatriates its earnings from Country Y and receives a $100 royalty from Country X, it will pay a total of $60 tax to countries X and Y. Under current law, the U.S. company's total tax on its $100 royalty income will equal the $10 tax collected by Country X plus $8 U.S. tax ($34 U.S. tax reduced by a $26 foreign tax credit). Thus the after-tax rate of return on the U.S. research and development will be 8.2%, more than the required 7%. Under the Proposal, the U.S. income tax on the royalty would increase to $24 ($34 U.S. tax reduced by a $10 foreign tax credit, the remaining $16 of credit would be excess that the company would be unable to use under the new rules). The total tax on the royalty would equal $34. Thus, the after-tax rate of return on the U.S. research and development would fall to 6.6%, less than the required 7%.

EXAMPLE 3

A U.S. company must decide whether to build a manufacturing facility in the United States with repatriated dividend earnings from Country X or to use those same earnings to build a manufacturing facility in Country X. The U.S. company has a CFC in Country X which pays it $100 of royalty income which is subject to a 10% rate of foreign tax. The CFC has $100 of manufacturing income, after payment of the royalty to its U.S. parent. Country X subjects the manufacturing

income to a 50% rate of tax. After the CFC pays the foreign tax on its manufacturing income, it has $50 available to pay a dividend to the U.S. company.

If the U.S. company repatriates the $50 dividend under current law, the company will pay $68 in tax ($60 to Country X and $8 to the U.S.) on its worldwide income of $200. If the U.S. company does not repatriate the $50 dividend, it will pay $84 in tax ($60 to Country X and $24 to the U.S.) on its worldwide income. Thus, there is a significant tax incentive to repatriate dividends under current law. These dividends are then available for investment in the United States. The Proposal would eliminate this incentive by driving the U.S. company into an excess foreign tax credit position. If the U.S. company were to repatriate the $50 dividend under the Proposal, the company would pay $84 in tax ($60 to Country X and $24 to the U.S., with excess credits of $16) on its worldwide income. A decision not to repatriate the dividend under the Proposal would result in the same $84 in tax cost.

EXAMPLE 4

A U.S. company must decide whether to build a new manufacturing facility that will generate $100 of income in Country X, where the tax rate is 15%, or in the United States. The U.S. company has a CFC in Country Y which pays it $100 of royalty income subject to a 10% rate of foreign tax. The CFC in Country Y has $100 of manufacturing income, after payment of the royalty to its U.S. parent. Country Y subjects manufacturing income to a 50% rate of tax. The U.S. company repatriates all of its foreign earnings. Under current law, if the U.S. company invests in Country X, it will pay $102 in tax ($15 to Country X, $60 to Country Y, and $27 to the U.S.) on its worldwide income of $300. It will pay the same $102 ($60 to Country Y and $42 to the U.S.) if it invests in the United States. Thus, under current law the U.S. company has no foreign tax credit reason to choose between investing in

the U.S. or the low tax jurisdiction. The tax cost to the U.S. company is the same because all of the foreign taxes paid by the company in either scenario are fully creditable in the United States.

Under the Proposal, the U.S. company would be in an excess foreign tax credit position prior to its new investment. If the U.S. company invests in Country X, it will be able to absorb some or all of the excess credits. If the U.S. company invests in Country X, the company will pay $102 in tax ($15 to Country X, $60 to Country Y, and $27 to the U.S.) on its $300 of worldwide income and the company will have no excess credits. However, if the U.S. company invests in the United States, it will pay $108 in tax ($60 to Country Y and $58 to the U.S.) on the same worldwide income of $300. The company also will have $16 in excess foreign tax credits. The U.S. company has a tax incentive to invest in Country X, instead of the United States, under the Proposal.

Mr. KOPETSKI. Thank you, Mr. Baker.

We will hear from Paul Oosterhuis, counsel to the Deferral Preservation Coalition.

STATEMENT OF PAUL OOSTERHUIS, COUNSEL, DEFERRAL PRESERVATION COALITION

Mr. OOSTERHUIS. Thank you, Mr. Chairman.

I am Paul Oosterhuis, representing the Deferral Preservation Coalition, which is a group of 20 high-technology companies that care about the general tax policy of deferral, and specifically the administration's proposal to cut back deferral with a new excess accumulations proposal, as they call it.

The proposal, simply put, is one that subjects to tax the assets of a foreign subsidiary through its U.S. parent, to the extent the passive assets of a foreign subsidiary exceed 25 percent of its total assets. It is an extension of the kinds of provisions that have been in present law, going all the way back to the beginning of the income tax, to limit incorporated pocketbooks or excess accumulations of passive assets.

The companies I represent do not have a problem with the concept of limiting excess accumulations. We really have two problems with the administration's proposal. First, it is retroactive in nature, and, second, the 25-percent limit on accumulations is much too low, particularly for high-technology companies. I would like to talk about both of these problems. I'll address the retroactivity point first.

I have been practicing tax law in Washington, DC, for 20 years, and this is the most retroactive proposal of this kind I have seen in that period of time, and I think it is probably unprecedented in the tax law. A company can have not $1 of income after the effective date of this proposal and be subject to the tax. A company can have not one new investment in passive assets under the provision and be subject to the tax. The tax is measured by your existing assets after the effective date, without regard to future income or future investments.

When the subpart F provisions were put into the Tax Code, for example, back in 1962, they only applied to posteffective date income. When the PFIC provisions, the passive foreign investment company provisions, were put in the code in 1986, which is the tightest existing limitation on accumulations that we have in present law, that provision only applied to income earned after the 1986 act was effective.

This provision has no such limitation in it. In fact, when we have talked to the Treasury Department, the bulk of the revenue that they say is picked up from this proposal, which is in the range of $700 million over 5 years, is picked up from the retroactive aspect. They say that they would lose most of the revenue if they got rid of the retroactive feature of the provision.

It seems to me that that is a very good argument why this committee should not adopt the provisions, because it is essentially a retroactive tax on prior buildups of assets.

Second, if you want to consider the provision after doing away with its retroactive aspects, you must then question whether the 25-percent limit on accumulations of passive assets is appropriate,

or is it too low. Today's law under the PFIC provisions has a 50-percent limit. So, essentially, if you do away with the retroactive aspects, what you are doing is adjusting the PFIC rules down to 25 percent from 50 percent.

It seems to us the best way to think about that issue is to think about at what rate companies earn returns on their assets each year, and how long a period of time they should have before they should be required to reinvest those earnings in active business assets, before triggering this kind of penalty tax.

In fact, high-technology companies and their foreign manufacturing facilities routinely earn 15, 25, 30 percent returns on assets each year, and those are returns that are certified by the IRS as being appropriate. The 1992 proposed regulations dealing with intercompany pricing contained an example of a 28.4-percent annual return for a foreign manufacturing company owned by a U.S. company.

If you have a 25-percent limit on the accumulation of passive assets, a company earning these kinds of returns must reinvest its profits in its business, essentially as it earns them. It will have maybe a 6-month lag to find an actual business investment for its profits. That is clearly too tight. You can say, well, maybe they ought to have 3 years, maybe they ought to have 4 or 5 years. The 50-percent limitation of present law gives you that kind of time frame or at least closer to that kind of time frame for reinvesting your profits.

But a 25-percent limit means you have to reinvest profits currently, and business just does not work that way. In fact, the proposal as it is, if it is adopted prospectively, will force companies to make artificial investments to avoid the penalty tax. The penalty tax is obviously a severe tax. It will confiscate 36 percent of your passive assets As a result, companies will make artificial investments to avoid that penalty. That is all that will be accomplished by the tax if it is enacted.

Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL OOSTERHUIS,
PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM,
ON BEHALF OF THE DEFERRAL PRESERVATION COALITION

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

APRIL 1, 1993

Mr. Chairman and Members of the Committee. My name is Paul Oosterhuis. I am a tax partner in the Washington D.C. office of the law firm Skadden, Arps, Slate, Meagher & Flom. I am here today representing the Deferral Preservation Coalition. The Deferral Preservation Coalition is an ad hoc group of companies from a variety of technology-based industries, including electronics, telecommunications, medical equipment and pharmaceutical. Attached to my statement is a list of our members.

John Young, the former CEO of Hewlett-Packard Company, one of our coalition members, will be testifying on the next panel from a businessman's viewpoint about the anti-competitive aspects of the Administration's proposal on deferral. I will not duplicate that effort. Rather, I am here to talk about the tax policy aspects of the proposal.

Deferral Cutback Proposal: A Description

The proposal would tax U.S. shareholders of controlled foreign corporations (CFCs) on their pro rata portion of the lower of two amounts: (i) the excess of passive assets over 25 percent of total assets or (ii) the CFC's total current and accumulated earnings and profits (E&P). As we understand it, the definition of passive assets will refer to or utilize similar rules to those in the passive foreign investment company ("PFIC") regime. The proposal would apply on a phased-in basis to all current and accumulated earnings beginning in taxable years after 1993.

Stated Tax Policy Goals of the Proposal

The Administration's explanation of the proposal states that it is intended to reduce the incentives under present law for companies to move plants abroad. For two reasons, nothing could be further from reality.

First, companies opening facilities abroad typically expect to reinvest their earnings in their foreign businesses. In fact, only if they have this expectation (i.e., if their earnings will be "permanently" invested in their business abroad) will their auditors allow them for financial statement purposes to realize any tax benefits of going abroad in the first place.

Second, if after an investment is made a company has a build-up of retained earnings invested in passive assets, its response to U.S. laws taxing the build-up will likely be to buy active business assets rather than repatriate the cash and pay the tax. In this way the proposal can, ironically, encourage companies to expand abroad rather than in the U.S.

Rather than being justified by discouraging runaway plants, the proposal can only be justified as an expansion of the series of provisions already in the Code dealing with corporations with excessive passive assets -- generally called "incorporated pocketbook" provisions. Several of these provisions in the Code today affect foreign corporations -- including the foreign personal holding company provisions, the personal holding company provisions of subpart F and the passive foreign investment company (or PFIC) provisions. Unfortunately, the Administration has provided no analysis of what deficiency exists in these provisions that require yet another set of complex rules. Indeed, to my knowledge, none of the many tax policy studies done since the 1986 Act -- including those done by Treasury at the request of this Committee -- have suggested that current law is in any way deficient in this regard.

Tax Policy Analysis

When one examines the Administration's proposal, it has two aspects that distinguish it from the provisions of present law and that should be closely scrutinized by this Committee: its retroactive application to prior year earnings and its 25% threshold.

Retroactive Application. The proposal applies to prior year accumulated earnings and assets. For example, a company can have losses in all years after enactment and still be subject to tax. It can have no new investments in passive assets in all years after enactment and still trigger the tax.

In this respect, the proposal constitutes an unprecedented departure from any existing provision of the Internal Revenue Code, including to my knowledge all prior provisions that have taxed the passive income or accumulated earnings of a corporation. Never in the history of the income tax law has the Congress imposed such a tax upon pre-enactment year earnings.

For example, the accumulated earnings tax provision, which was the original incorporated pocketbook provision enacted in 1913, applied at the shareholder level to only "that part of the profits of the corporation for the year which might have been distributed but were not distributed." As such, it only applied to current earnings after the enactment date.

Similarly, the personal holding company tax rules, which were enacted in 1934 and the foreign personal holding company rules enacted in 1937, only apply to the corporation's post-enactment income.

The Subpart F rules, enacted during the Kennedy Administration in 1962, only applied to earnings after 1962. Indeed, even today, the accumulated E&P accounts of CFCs go back only to 1962 so as to not tax retroactively the income earned by these entities prior to the enactment of these rules. Section 956, which taxes a CFC's earnings invested in U.S. property, is probably most analogous to the Administration's current cutback proposal. Yet even that section, enacted in 1962, only targets property acquired after 1962. Thus, earnings invested in U.S. property acquired before the enactment of Section 956 in 1962 are not only exempted from tax

under the Section 956 investment in U.S. property rules, but are totally irrelevant in determining the amount of current inclusion under that section.

Finally, the PFIC rules, which were enacted most recently in 1986, also only target post-enactment earnings. Under those rules, a foreign corporation is a PFIC if 75% or more of its gross income is passive or if 50% or more of the value of its assets are passive. The U.S. shareholders of a PFIC have the option of either paying tax with an interest charge when there is a distribution of earnings accumulated after 1986 or paying taxes on a current basis with respect to the current earnings of the PFIC. In either case, the rules only apply to earnings from years after its enactment. Distributions attributable to pre-enactment years are simply not considered taxable PFIC distributions, and are not subject to the interest charge under the PFIC rules.

It is particularly surprising -- and disturbing -- that Treasury would make such a retroactive proposal. Over the years the Treasury has consistently advocated the fundamental principle that tax legislation should not apply retroactively. It is on this basis that Treasury routinely opposes legislation of interest to many members of this Committee that benefit taxpayers by providing retroactive relief from some unintended or poorly considered aspect of the law. The only justification for the retroactive aspects of Treasury's deferral proposal is a pure and simple grab for revenue.

<u>The 25% Threshold</u>. As discussed above, Treasury has provided no analysis of why it concludes a corporation with 25% of its total assets passive in nature has sufficient "excess accumulations" that it should be subject to a tax penalty. One logical method of analyzing this issue would be to ascertain how long a company should be able to retain its earnings before reinvesting them in its business. This analysis depends largely on the rate of return a company earns on its business assets. If a company earns a 5 to 10% rate of return on its assets each year, it can accumulate three to five years' earnings before it would accumulate earnings totaling 25% of total assets. Companies with heavy investments in physical plant and facilities tend to earn returns in this range. Successful high tech companies, however, often earn significantly higher returns -- more like 15% or even 25% -- because of the higher levels of risk that accompany their investments. These returns are clearly consistent with the section 482 pricing rules. (For example, the 1992 proposed regulations included an example of a foreign manufacturing subsidiary permitted to earn a 28.4% return on assets annually. <u>See</u> Example (1) of Prop. Reg. § 1.482-2(f)(11)).

Under the Administration's proposal, the company in the IRS 1992 proposed regulation example would have to reinvest its earnings in business assets within six months after the end of each year. It is difficult to conceive of any tax policy rationale for requiring that tight a reinvestment schedule. Indeed, the PFIC provisions, which are triggered when passive assets exceed 50% of total assets, appear to be clearly sufficient to prevent any incorporated pocketbook abuses for this type of company.

The Provision Disproportionately Hits High Tech Companies

As the above rate of return analysis indicates, the proposal disproportionately affects high tech companies because its 25% threshold is very tight for companies which have high rates of return. The proposal discriminates against high tech companies in other ways as well.

The proposal favors companies that can debt finance their foreign manufacturing operations. Such companies can utilize profits to pay off debt and can take out new debt to finance expansion which can also be paid off through retained earnings. Companies with substantial debt capacity associated with foreign manufacturing thus can easily avoid the 25% threshold. Equity financed companies, however, must save up their retained earnings to finance their next facility. These companies can easily run up against the 25% threshold. High tech companies are most often equity financed; the debt-equity ratios of major companies in the electronics and pharmaceutical industries are perhaps the lowest of any manufacturing industry. Thus, these companies have the least ability to avoid the 25% threshold by debt financing.

Finally, the provision discriminates against high tech companies because a substantial portion of the assets of their foreign manufacturing facilities are likely to relate to intangibles rather than plant and equipment. These intangibles may have substantial value (and thus substantially increase the 25% threshold), but determining the value of these intangibles is subjective and therefore subject to dispute. It can thus be readily predicted that enactment of the 25% threshold will lead to serious valuation questions with respect to high tech foreign manufacturing facilities. Other companies, with investments dominated by plant and equipment costs, have more readily ascertainable asset values, resulting in the more predictable application of the 25% threshold.

Conclusion

The Administration proposal is retroactive in an unprecedented manner. That aspect of the proposal should clearly be eliminated by this Committee.

Once that is done, the merits of modifying the current law incorporated pocketbook provisions should be questioned. Treasury has provided no analysis of why the 50 percent threshold of existing law is inadequate. Further, at least for high technology companies properly earning annual rates of return of 15 to 25%, a 25% threshold is clearly too low, and the 50% limitation of present law is more than adequate to prevent significant abuses.

DEFERRAL PRESERVATION COALITION MEMBERSHIP

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Amdahl Corporation
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Computer and Business Equipment
Manufacturers Association

Electronic Industries Association

Pharmaceutical Manufacturers Association

Mr. KOPETSKI. Mr. Oosterhuis, thank you very much for your testimony.

We will hear from Anthony Principato, from Tambrands, Inc.

STATEMENT OF ANTHONY J. PRINCIPATO, VICE PRESIDENT OF TAXES, TAMBRANDS INC., WHITE PLAINS, NY

Mr. PRINCIPATO. Mr. Chairman and members of the committee, thank you for this opportunity to testify.

My name is Anthony Principato, vice president of taxes of Tambrands Inc. I am here to urge you to reject the administration's proposal to treat royalties paid by foreign subsidiaries as passive income for foreign tax credit purposes. These royalties are paid out of income earned in the active conduct of integrated foreign business operations and should be treated the same as other active income from those operations.

Before turning to the merits of the proposal, let me tell you about Tambrands, so that you can understand our concerns. Tambrands is a Fortune 500 company headquartered in the United States, where we employ 2,000 people. Tambrands has only one product, Tampons, which we manufacture and distribute worldwide under the trade name Tampax. Over 99 percent of the products sold by Tambrands in the United States are made here. We export over 10 percent of our U.S. production.

Tambrands is also a leading manufacturer and distributor of Tampons throughout the world. In order to compete internationally, our foreign subsidiaries manufacture our products in strategically located facilities outside the United States. These plants provide us with an effective regional presence that gives us credibility with our distributors and customers. Our foreign subsidiaries pay royalties to us for the use of the Tampax trade name and for manufacturing intangibles.

Like other U.S. companies, Tambrands is presently taxed in the United States on the operating income of our foreign subsidiaries, as that income is repatriated. U.S. tax treatment of that income is effectively the same, regardless of whether the income is repatriated through dividends or royalties or earned directly by a foreign branch. We have always viewed this income as fair and correct, because it insures a level playing field.

The administration is now proposing to treat foreign operating income that is repatriated in the form of royalties differently from other foreign operating income. Under this proposal, foreign taxes paid on the operating income of foreign subsidiaries could not be credited against U.S. taxes on foreign royalty income. There are many reasons why this proposal should be rejected, but here are several reasons that are most compelling to Tambrands:

First, it has been suggested that the proposal is designed in part to address the problem of runaway plants. That term means different things to different people. A broad definition would include any foreign manufacturing operations of a U.S. company, if the decision to manufacture overseas as oppose to here is based on U.S. tax considerations.

Regardless of how a runaway plant is defined, this proposal will not curb runaway plants in any meaningful way. Typically, royalties represent only a small portion of manufacturing income. Most

of the income generated from a runaway plant would not be considered passive income and would be unaffected by this proposal.

Tambrands has no objection to appropriately drafted legislation to curb runaway plants, because we have no runaway plants, as I understand the term. If Congress wants to address the plant issue, it certainly must be possible to draft legislation that directly addresses the issue and does not adversely affect so many companies that do not have runaway plants.

Second, the proposal is a significant departure from current U.S. tax policy. During consideration of tax law changes in 1986, this committee recognized the desirability of encouraging U.S. corporations to charge appropriate royalties for their overseas subsidiaries for the use of intangibles developed or owned by the U.S. parent.

This proposal, however, would treat dividends more favorably than royalties. This will put pressure on U.S. companies to minimize royalties and will provide an incentive to convert royalties into dividends.

Third, this proposal is at loggerheads with the administration's proposals on the R&E allocations. On the one hand, the proposal on R&E allocations encourages U.S.-based R&E, regardless of where in the world the technology developed through that R&E is eventually used. The royalty proposal, on the other hand, negates this incentive for companies that receive royalties for the use of that R&E from their foreign affiliates.

In addition, the proposal encompasses trade name royalties, as well. This proposal impacts U.S. companies that have chosen to keep the worldwide rights to their trade names in the United States and discourages U.S. companies from continuing such politics. It makes no sense for the United States to be adopting new tax laws that discourage both U.S.-based R&E and the use of U.S.-developed intangibles.

In conclusion, we at Tambrands are perplexed as to why our foreign operations are being selected for a tax increase. We are doing exactly what the United States encourages U.S. corporations to do. We export U.S.-manufactured products, when that makes sense. We are not engaged in any runaway plant activities. We license our U.S.-developed intangibles to our foreign subsidiaries in order to compete overseas. Now suddenly we find ourselves facing a major tax increase, precisely because we have been successful in achieving these goals.

It is our hope that Congress will realize this proposal is not sound tax policy and is not in the best overall interest of the United States.

Once again, thank you for the opportunity to testify. I will be happy to answer any questions you may have.

[The prepared statement and attachments follow:]

STATEMENT OF ANTHONY J. PRINCIPATO
VICE PRESIDENT OF TAXES
TAMBRANDS INC.

CONCERNING

PRESIDENT CLINTON'S PROPOSALS
FOR PUBLIC INVESTMENT AND
DEFICIT REDUCTION

BEFORE THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 1, 1993

Mr. Chairman and Members of the Committee:

I am the Vice President of Taxes of Tambrands Inc., a New York-based corporation engaged in the worldwide manufacture and distribution of tampons. I am here today to urge you to reject or modify substantially the Administration's proposal to treat royalties paid by controlled foreign corporations engaged in active businesses as passive income for foreign tax credit purposes because, in the case of Tambrands and other similarly situated taxpayers, the royalty income affected by the proposal is income derived from the active conduct of integrated foreign business corporations and should be treated the same as other active income repatriated from foreign operations.

I. INFORMATION ABOUT TAMBRANDS

Tambrands Inc., founded in 1936, is a Fortune 500 company with annual sales revenues of approximately $700 million.[1] Our only product, tampons, is sold under the "Tampax" trade name in more than 150 countries worldwide and is a worldwide sales leader in feminine hygiene. Tambrands' mission is "to be the leading supplier of all types of tampons in each market we serve on a worldwide basis."

Tambrands' headquarters and primary manufacturing facilities are located in the United States, where we have 2,000 employees, of whom approximately two-thirds are women. Virtually all of the products sold by Tambrands in the United States are manufactured domestically. In addition, Tambrands exports over 10% of its U.S. production, a percentage that has grown steadily in recent years.

In order to compete internationally, Tambrands also manufactures its products in eight strategically located manufacturing facilities outside the United States. Tambrands' reasons for establishing overseas manufacturing facilities are based on business considerations, focusing on manufacturing near the local market.[2] In some countries, such as the United Kingdom, Tambrands has a 60% market share. As the market leader,

[1] Tambrands is a significant domestic taxpayer. Based on 1991 data, Tambrands ranks in the top 200 of Fortune 500 U.S. corporate income taxpayers even though it ranks number 442 in terms of sales. These results are from tabulations of Fortune 500 companies prepared by the Policy Economics Group of KPMG Peat Marwick using 1991 financial reporting information available from Standard & Poor's Compustat Services, Inc. The Fortune 500 list includes the 500 largest nonfinancial, publicly traded companies in the United States ranked by sales. The numbers represent federal and state current taxes.

[2] In fact, most of Tambrands' offshore manufacturing plants are located in countries such as the United Kingdom and France, where corporate income tax rates are roughly comparable to the U.S. federal income tax rates.

we must have manufacturing facilities near our customers to supply local demand and respond quickly to changes in market developments. Our foreign plants provide us with an effective regional presence that gives us credibility with our distributors and customers. In addition, local production minimizes business risks where goods might otherwise have to be shipped over long distances.

Tambrands' foreign manufacturing and distribution operations are conducted through its foreign subsidiaries. Tambrands licenses its trade name and technology to its foreign subsidiaries in exchange for royalties.

II. CURRENT LAW

Sections 901 and 902[3] allow U.S. taxpayers a credit for foreign income taxes paid and deemed to be paid. An overall limitation on the credit is imposed under Section 904(a). The foreign tax credit allowed may not exceed the U.S. tax imposed on the taxpayer's foreign source income. This foreign tax credit limitation is imposed separately for special categories, or "baskets," of income, such as passive income, high withholding tax interest, shipping income, etc. Operating income falls into the basket for "general limitation income." The purpose of imposing separate foreign tax limitations on different types of income is generally to prevent cross-crediting of high foreign taxes on general limitation income against the U.S. tax imposed on other foreign passive income subject to low foreign taxes.[4]

Income in the passive basket includes income that would be foreign personal holding company income for purposes of Subpart F of the Code, such as certain interest, dividends and passive royalties. Royalties derived in an active business from unrelated parties is general limitation income, rather than passive income.

In addition, there is a "look-thru" rule in the case of foreign source dividends, interest and royalties received or accrued by a U.S. shareholder from a controlled foreign corporation ("CFC"). For purposes of determining the foreign tax credit limitation under Section 904(d), such income derived from the CFC is allocated to the various baskets based on the character of the income of the CFC. Thus, if a royalty derived from a CFC is allocable to the CFC's active business income, the royalty will be general limitation income in the hands of the recipient. The purpose of the look-thru rules is to attempt to achieve a parity under the foreign tax credit rules between taxpayers who derive foreign source income through foreign branches and taxpayers who earn foreign income through controlled foreign subsidiaries.[5]

III. ADMINISTRATION'S PROPOSAL

With respect to the foreign tax credit limitation, the President's proposal would eliminate the look-thru rule on royalty income by allocating all foreign source royalty income to the passive income basket, without regard to whether the royalties are derived in the active conduct of a trade or business. The proposal would be effective for taxable years beginning after December 31, 1993.

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[3] All references to "Section" are to the Internal Revenue Code of 1986, as amended ("Code").

[4] The General Explanation of the Tax Reform Act of 1986 prepared by the Staff of the Joint Committee on Taxation (May 4, 1987) ("1986 Act Blue Book") at page 856.

[5] See S. Rep. No. 313, 99th Cong., 2d Sess. 314 (1986).

IV. DISCUSSION AND ANALYSIS

Tambrands opposes the Administration's proposal to treat all foreign source royalty income as passive income for foreign tax credit limitation purposes (hereafter referred to as the "royalty proposal" or the "proposed legislation"). In particular, we do not believe that there is a compelling policy or economic rationale for treating royalty income differently from other payments received from CFCs engaged in active business operations abroad. The reasons stated for the proposal and the proposal's potential effects do not reflect the realities of the global marketplace. The proposal would adversely impact on Tambrands' ability to compete internationally, would reduce our return on investment, and would reduce our rate of growth and ability to invest. We also believe the proposal would have similar consequences for other U.S. multinational companies.

By way of summary, Tambrands opposes the Administration's proposals on foreign source royalty income for the following reasons:

- The royalty proposal deviates from the current U.S. tax policy that recognizes that all payments, including royalties, received by a U.S. company from a CFC engaged in an active business should be viewed as a distribution of the operating profits of the active business conducted by the CFC in the foreign country.

- The asserted tax policy grounds for the royalty proposal, as set forth in the Summary of the Administration's Revenue Proposals published by the Department of the Treasury (February 1993) (the "Summary"), do not support the proposed legislative change.

- The likely impact of the royalty proposal is contrary to the purpose of the Administration's proposal to encourage U.S.-based research and experimentation ("R&E").

- Unlike an across-the-board income tax rate increase that affects all taxpayers in an evenhanded manner, the enactment of the royalty proposal would amount to a punitive tax on U.S. companies that have been successful in generating worldwide demand for their products. Such a tax is counterproductive if one assumes that the United States wants to encourage the export of its technology and products.

A. The proposal is a radical departure from current U.S. tax policies

1. United States tax policy has long encouraged and required U.S. corporations to charge significant royalties to their overseas subsidiaries for use of intangibles developed and/or owned by the U.S. parent. Particularly during the last decade both Congress and the Internal Revenue Service have focused on insuring that U.S. multinationals charge appropriate royalties for the use of intangibles by their foreign subsidiaries.

For example, Section 367, which governs the taxation of certain outbound transfers of property from the United States, was modified in 1984 and again in 1986 generally to prevent U.S. companies from transferring intangibles developed domestically without charging or being deemed to charge a royalty commensurate with the income attributable to such intangible. Similarly, Section 482 requires the royalty associated with a transfer or license of an intangible between affiliated parties to be commensurate with the income generated by the intangible. Recently promulgated regulations under Section 482 confirm that the appropriate payment for the use of an intangible by a related party should be in the form of a royalty.[6]

As discussed below, the proposed legislation would encourage U.S.-based multinationals to charge the lowest possible royalties to their foreign subsidiaries, an

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[6] See Temporary Regulation Section 1.482-4T(e)(1).

objective that is clearly at odds with recent Congressional and administrative actions in the areas of Sections 367 and 482.

2. Current U.S. tax law recognizes that all payments, including royalties, to a U.S. company from its CFC engaged in an active business should be viewed as a distribution of the operating profits of the active business conducted in the foreign country.

In 1986 Congress amended the foreign tax credit provisions of the Code to subject dividends, interest, rent and royalties received from CFCs to the new separate basket limitations and to the general basket limitation in accordance with "look-thru" rules that take into account the income of the CFC itself. For foreign tax credit purposes, the effect of the look-thru rules is to allocate a payment in the hands of the recipient to a basket or baskets based on the type of income earned by the CFC out of which the payment is made. The look-thru rule was extended to interest, rents and royalties because such payments often serve as alternatives to dividends as a means of repatriating earnings from a CFC, and so that such payments "would not be discouraged."[7]

The House Ways and Means Committee, during its consideration of the 1986 changes to the foreign tax credit system, indicated the desirability of adopting a look-thru approach that encouraged the payment of royalties.[8] Congress clearly understood the effect of the look-thru approach for royalties in 1986. Now, when the goal is to enhance the domestic revenue base, Congress should not modify these rules as currently proposed because the royalty proposal will encourage U.S.-based multinationals to recover foreign earnings through the receipt of dividends or to take other steps to redress the negative impact of the proposal.

3. Examples. The equivalent treatment of dividends and royalties under current law is demonstrated in Examples A and B in the Appendix to this statement. Those two examples indicate that, under the assumptions described in the Appendix, the worldwide taxation of a U.S.-based multinational corporation is the same regardless of whether the income of the corporation's CFC is repatriated through royalties or dividends. The difference is that in the case where the CFC pays royalties to its U.S. parent a portion of the total tax is paid to the United States (Example A), whereas when only dividends are paid no portion of the total tax is paid to the United States. Thus, to insure that it receives its fair share of the total tax payments, current U.S. tax policy and rules are designed to encourage and require U.S. corporations to charge their CFCs appropriate royalties.

4. The royalty proposal would violate the basic U.S. tax policy objective of tax neutrality between branch operations and subsidiaries. Another of the principal purposes underlying enactment of the look-thru rules was to reduce disparities that might otherwise occur between the amount of income subject to a particular foreign tax credit limitation when a taxpayer earns income abroad directly (as though a foreign branch) and the amount of income subject to a particular limitation when a taxpayer earns income through a CFC.[9] This purpose is reflective of a longstanding goal of U.S. tax policy to achieve tax parity upon a repatriation of overseas earnings between taxpayers conducting business through branches and those who operate through subsidiaries. Section 902, which allows a U.S. corporation to claim a "deemed paid" foreign tax credit for the underlying taxes paid by a 10 percent or greater owned foreign subsidiary on its distributed earnings, was added to the Code precisely to foster this goal. Similarly, Section 884 imposes a branch profits tax and a branch level interest tax in an effort to treat foreign corporations engaged in business in the United States similarly regardless of whether they conduct their operations through a U.S. branch or a U.S. subsidiary. This parity principle has withstood the test of time and it should continue to be a cornerstone of U.S. international tax policy.

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[7] 1986 Act Blue Book at page 866.

[8] H.R. Rep. No. 426 ("House Report"), 99th Cong., 1st Sess. 341 (1985).

[9] 1986 Act Blue Book at page 866.

B. The reasons in support of the royalty proposal, as set forth in the Summary, do not support enactment of the proposed legislation

The Summary asserts that the existing foreign tax credit rules "can result in a tax preference for licensing of intangible property to a foreign person for use in production activities abroad."[10] Although the Summary does not elaborate on this point, it has been suggested that the quoted language indicates that the royalty proposal is intended, at least in part, to discourage so-called "runaway plants."[11] If this is true, there are at least two significant points that must be made in response.

First, the royalty proposal in no way distinguishes between runaway plants and other foreign operations of U.S. multinationals. For example, Tambrands products sold in the United States are manufactured in the United States. Tambrands does not have any foreign operations that even remotely can be described as runaway plants. Tambrands manufactures overseas in order to compete effectively overseas. Notwithstanding these facts, the Administration's royalty proposal would affect all of Tambrands' foreign manufacturing operations to the same (or even greater) extent as it would affect runaway plants. Tambrands would have no objection, and would not be here today, if the proposed legislation were limited to royalties paid by runaway plants.

Second, the Administration's royalty proposal, rather than discouraging runaway plants, would create an additional set of incentives to encourage taxpayers to shift manufacturing and R&E operations overseas:

- The royalty proposal would encourage U.S. corporations to develop and own R&E and marketing intangibles overseas, and thereby avoid the adverse tax costs of the proposal. For example, a foreign subsidiary of a U.S. company may create marketing intangibles overseas by providing brand support, advertising, and other services necessary to enhance the value of a brand that ultimately becomes a trademark. Other intellectual properties may be developed through R&E conducted abroad or by entering into cost-sharing agreements with overseas affiliates. The earnings of the foreign subsidiary would be repatriated as dividends subject to the general limitation income basket, thereby entirely avoiding the passive income basket on royalty income. It seems incongruous for the Administration to be advocating a proposal that would have the impact of shifting R&E offshore at the same time the Administration is attempting to encourage U.S.-based R&E.

- An intended consequence of the royalty proposal is to reduce the amount of foreign tax credits that can be utilized by U.S. multinational corporations. This will result in an increase in the amount of excess (or unused) foreign tax credits. In an effort to utilize these excess foreign tax credits, a U.S. corporation may relocate U.S.-based manufacturing activities abroad to generate low-tax foreign source manufacturing income. The additional low-tax foreign source manufacturing income generated by the relocated manufacturing operations, when repatriated, would be included in the general limitation income basket and offset by the excess foreign tax credits. Although Tambrands' practice is to manufacture abroad to satisfy market demands, other companies may compensate for the effects of the royalty proposal by taking steps to average their foreign tax rates in the general limitation income basket by transferring their U.S. production facilities to a low-tax foreign jurisdiction.

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[10] Summary at page 58.

[11] A threshold question is what constitutes a "runaway plant." This term may mean many things to different people, but for purposes of this statement we have assumed that the term means any foreign manufacturing operations of a U.S. company where the decision to locate the operations outside the United States was made based on U.S. tax considerations.

- A corollary result of moving intangible ownership and production outside of the United States would be the loss of highly skilled and well-paid jobs in the United States. This result obviously would be most undesirable for the U.S. economy and contrary to a stated objective of this proposal.

C. The likely impact of the royalty proposal is contrary to the purpose of the Administration's proposal to encourage U.S.-based R&E

The Administration has linked the royalty proposal with a proposal to allocate R&E expenses to the place of performance. This is accomplished by using the revenues from the royalty proposal to finance the cost of the R&E proposal. The Summary explains that the reason for the R&E allocation proposal is to "encourage United States corporations to perform research in the United States."

The R&E allocation proposal encourages U.S.-based R&E by permitting U.S. companies to deduct 100% of their domestic R&E expenses when calculating their U.S. source income. This is true regardless of where the product of the R&E is later used to generate income. There is no doubt that this proposal is a positive step in encouraging U.S.-based R&E.

Coupling the R&E allocation proposal (and its purpose) with the royalty proposal, however, is contradictory. On the one hand, the Administration is encouraging U.S. companies to conduct their R&E in the United States regardless of where the R&E is used. On the other hand, the Administration through the royalty proposal is discouraging U.S.-based R&E by treating royalties paid by foreign subsidiaries to their U.S. parent corporations as passive income. The Administration should adopt a single consistent policy encouraging U.S.-based R&E. The R&E allocation proposal and the royalty proposal send conflicting signals on this question.

D. The enactment of the royalty proposal would in effect constitute a penalty tax on those U.S. companies that have successfully generated international demand for their products

As mentioned above, the Administration has linked the proposal to allocate R&E expenses to the place of performance with the royalty proposal. Whether or not intended, the effect of these proposals is to selectively and arbitrarily segregate companies into winners and losers through an allocation of tax benefits and costs.

The proposal requires Tambrands and other similar companies to pay for the benefits of the performance based R&E allocation rule through the passive characterization of their royalties even though their success in creating a global market for their products results from marketing efforts and not from R&E. Tambrands and other similarly situated companies that must compete on their own merits against global competitors cannot operate by manufacturing solely within the United States. To be competitive and successful, we must be concerned primarily with the needs of our customers and the capabilities of our competitors. We must be able to provide products on time, as needed, and more satisfactorily than our competitors. Decisions on plant location are dictated by these considerations. We have taken the initiative to build a worldwide reputation, and hence worldwide demand, for our products and we must operate in an efficient manner. We should not be penalized for our success by a selective and arbitrary tax increase.

While Tambrands has no present intention to change its business operations, the proposed legislation would require us to pay a significantly higher amount of total taxes due to our international activities. As a result, we would have less capital available to invest in the expansion of our business, and our ability to compete in the global market would be impaired. With a decline in our after-tax rate of return, we may have less access to capital markets. This is not in the interest of our shareholders, or our employees, or the United States.

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In conclusion, we at Tambrands are perplexed as to why our foreign operations are being selected out for a tax increase. We are doing exactly what the United States wants to encourage U.S. corporations to do. We are exporting U.S. manufactured products when that makes sense. We are not engaged in any runaway plant activities. We license our U.S.-developed intangibles -- marketing and technical -- to our foreign subsidiaries in order to compete overseas against international competitors. Our overseas activities generate operating profits that are repatriated to the United States in the form of dividends and royalties. We now find ourselves facing a major tax increase that is imposed on us because we have been successful in achieving these goals. It is our hope that Congress will realize that this proposal is not sound tax policy and is not in the best overall interest of the United States.

APPENDIX

Set forth in this Appendix are two examples demonstrating in a relatively straightforward manner the current U.S. taxation of dividends and royalties paid by a foreign operating subsidiary to its U.S. parent corporation (Examples A and B). Examples A and B are premised on the following assumptions:

1. A U.S.-based company ("U.S. Parent") owns all or substantially all of the outstanding stock of a controlled foreign subsidiary ("CFC"). With the exception of the income earned by CFC, U.S. Parent does not earn, directly or indirectly, any other foreign source of income.

2. CFC is a Country X corporation engaged in the active trade or business of manufacturing products that it distributes and sells throughout the region where it is headquartered.

3. None of the goods manufactured by CFC are exported to, or sold in, the United States, and the decision to set up manufacturing operations in Country X was not based on U.S. tax considerations. Thus, CFC is not a runaway plant.

4. For purposes of Example A, CFC remits annual royalties of $10 to U.S. Parent in payment for the use by CFC of U.S. Parent's tradename and technology related to the products manufactured by CFC.

5. CFC earns $110 from its manufacturing and distribution operations in Country X before the payment of royalties or taxes.

6. Both the United States and Country X impose corporate income taxes at a flat rate of 36%.

7. Country X, either by law or treaty, does not impose a withholding tax on royalties or dividends paid by CFC to U.S. Parent.

8. CFC distributes all of its net distributable income (i.e., gross profits from operations less royalties less taxes) to U.S. Parent in the form of a dividend.

9. All amounts are in U.S. dollars.

	Example A Dividend and Royalty Current Law: $10 Royalty Paid to U.S. Parent		Example B Dividend Only Current Law or Administration Proposal: No Royalty Paid to U.S. Parent	
	CFC	US Parent	CFC	US Parent
(1) Profits before Royalty and Taxes	$110.0		$110.0	
(2) Royalty Paid to U.S. Parent	(10.0)	$ 10.00	-	
(3) Country X Taxable Income	$100.0		$110.0	
(4) Country X Tax	(36.0)		(39.6)	
(5) Dividends Distributed to U.S. Parent	$ 64.0	64.0	$ 70.4	$ 70.4
(6) Section 78 Gross Up		36.0		39.6
(7) U.S. Taxable Income		$110.0		$110.0
(8) Tentative U.S. Income Tax		39.6		39.6
(9) Less: Foreign Tax Credit		(36.0)		(39.6)
(10) Final U.S. Income Tax		$ 3.6		-
(11) Worldwide Tax Burden ((4) + (10))		$ 39.6		$ 39.6

Mr. KOPETSKI. Thank you very much. And as I stated earlier, the full testimony of each of you will be entered and made a part of the record.

Treasury Secretary Bentsen has testified before this committee that the royalties provision prevents erosion of the U.S. income base where companies—and I quote from his testimony—"take deductions for R&D against U.S. income and the government does not pick up the tax in many cases on the royalty income from abroad."

Mr. Bretz, I was curious as to your response to the Secretary's rationale on this.

Mr. BRETZ. First of all, the royalties that we are talking about here are not U.S. source. They are foreign source, so we are not eroding the U.S. base in that sense.

Secondly, I think the overall theme that was adopted in the 1986 act about taxing active income separately from passive income, and that this is nothing more than a slice of active income, suggests that going down that path of separating royalties into passive categories and taxing them on sort of a schedular basis begins to open up a pandora's box, if you will, in terms of where do we stop.

Mr. KOPETSKI. Mr. Baker, how easy will it be for U.S. multinationals to restructure their business transactions to avoid or mitigate the effects of this proposal?

Mr. BAKER. Well, I think that probably several things would happen. In the short term, you probably would bring back home less foreign dividends. If you are not going to be allowed to credit your foreign taxes against those dividends, because of royalties not now in the same basket, you will just bring back less dividends from abroad. You will reinvest abroad and keep the money invested in plant and equipment there.

Second, I would anticipate that over time you would see a shift of research activity being conducted outside the United States, rather than inside the United States. This probably would occur through joint ventures or singly by research conducted by your overseas subsidiaries, so that the royalty income being generated from that research then being conducted abroad would be more favorably treated.

I think there is a very important point that has to be understood: When you extract cash flows from industry, particularly cash flows that are of an equity nature, in other words, earned income, you hit right directly at the discretionary part of American investment. So when you take cash flows away from the R&D activity of U.S. companies, you reduce R&D activity in the United States.

So this really goes right to the heart of what makes it possible for American companies to operate successfully abroad. It is the strength of our technology. We are in the air business. Air in Europe is just as good as the air here. It is the uniqueness of American technology created in our laboratories that we exploit around the world that generates those revenue incomes and generates the dividend incomes. So when you attack that, you attack really at our strength, and that is wrong.

Mr. KOPETSKI. It seems that if you look down the road where our future is economically, it is not with the low-wage jobs. We cannot compete against Taiwan or Vietnam some day or China.

Mr. BAKER. You are absolutely correct. We will never have wage rates that are as low as they are in other parts of the world. We have got to win on the basis of value added technology and build more know-how into the components of the products that we market around the world. We are doing reasonably well at that. The present law gives a return to the U.S. shareholder on the revenues we bring back. All we are saying is keep that royalty income combined with the dividend income, so that we can have a reasonable base upon which to assess the foreign taxes that we are already being assessed.

Mr. KOPETSKI. Our problem, of course, is the deficit, and the President I think has been one of the greatest leaders of the century in taking very difficult issues to the Congress and the people on that. If we made an adjustment in this committee in terms of royalties, we have got to make up the revenue source some place. Any ideas?

Mr. BAKER. Well, I think, as a businessman, we would say the place to start making up for a decrement in the budget proposals is to look at the cost side of Government, but I understand you have already been doing some work in that regard.

Mr. KOPETSKI. That's right. Thank you.

Mr. BAKER. So if you had to look solely at the revenue side, I think that, from an industry standpoint, we would think the preservation of the current treatment of royalty income is relatively more important to Americans' ability to compete around the world than the short-term incremental investment tax credit is. So I think, at least for this group that I am speaking for and I think most American manufacturers, we would trade off that short-term investment tax credit for preservation of the royalty income rules as they now stand.

Mr. KOPETSKI. I appreciate that testimony and that suggestion. Mr. Pepper.

Mr. PEPPER. I would support that. I feel there is far more at stake here. Speaking for Procter & Gamble, we do not think the investment tax credit is going to drive significantly positive behavior in terms of investment.

Recognizing the need to get revenue, the other thing I would walk away from, is taking the R&E allocation up from 64 to 100 percent, which is proposed as an offset for, and which in fact, from the figures I have seen, effectively eliminates about half or two-thirds of the revenue of the royalty change. I would get rid of this royality change, which is going to be so invidious on both jobs, and on capital inflows which are needed for investment in this country. Those are two things that I think I would go after and clearly come out ahead.

Mr. BAKER. I would agree with that second point, too.

Mr. KOPETSKI. Thank you. Other thoughts on this particular issue?

[No response.]

As a new member of the committee, I appreciate that it is not easy for you to make these kinds of suggestions, but those are the kinds of decisions that we make in this committee, and so it is very helpful.

Mr. Santorum may inquire.

Mr. SANTORUM. Thank you, Mr. Chairman.

Thank you, gentlemen, for your testimony. I appreciate it. I want to followup what Mr. Kopetski was saying. The number that Mr. Camp just shared with me is that this proposal raises about $2.8 billion, and you are saying you are willing to forego the ITC, which I think was around $10 or $12 billion, which is more than paying for it.

The proposal that you talked about, Mr. Pepper, do you have any idea of what the revenue impact of it is on the R&D side?

Mr. PEPPER. I think the figure you are referring to may be net of that R&D figure.

Mr. SANTORUM. It is?

Mr. PEPPER. It could be. The figure I have heard is about $2 billion, which would net the pickup from this royalty change and the tax.

Mr. SANTORUM. That may be true, because it was $1.8 billion, and now——

Mr. PEPPER. We think it may be a net of that figure.

Mr. SANTORUM. OK.

Mr. PEPPER. To answer your question, the figures I have heard is that there would be about $6 billion, and think this is still at issue, but $6 billion that is involved in this royalty, and it would be offset by approximately $4 billion going away with the R&E allocation.

Mr. SANTORUM. You said you would be willing to forego that provision?

Mr. PEPPER. I think the tradeoff between the two is a very bad trade, so, yes, absolutely.

Mr. SANTORUM. Do you speak for a particular industry, or do you think most——

Mr. PEPPER. I am speaking for the group I am representing, the NFTC and Procter & Gamble.

Mr. SANTORUM. Is there anyone else who feels differently about that, maybe just from a pure tax standpoint?

Mr. BRETZ. My group feels the same way.

Mr. BAKER. I think I could speak for 12,000 U.S. manufacturers when I say that.

Mr. OOSTERHUIS. I think that is right, the business community generally would be quite supportive of that.

Mr. PEPPER. You see, the difference that we are looking at in terms of what the——

Mr. SANTORUM. Excuse me. Who asked for this? I understand how the President comes up with this proposal, but where does he get this? [Laughter.]

If nobody is asking for the increase in the R&D, where does he come up with this proposal?

Mr. PEPPER. I just don't think it has had a chance to be studied, in fact. Probably, you know, the facts that are coming out here probably have not been seen this way and our job is to now get them in front of people so they can see these puts and calls.

Mr. BAKER. I think it was originally suggested as an offset to runaway plants, but clearly it misses the target very, very dramatically. It has nothing to do really, our ability to exploit our technology around the world has nothing to do with runaway plants.

We don't operate abroad in order to have our royalty income taxed in certain ways. We operate abroad, because that is the only way we can serve international markets.

There is one thing that is important, very important: Two-thirds of the world's markets for manufactured products lie outside the United States, and the only way that we can go after those markets is with superior technology, and the roots of our success lie in that technology. We should be doing everything——

Mr. SANTORUM. What this proposal does, Mr. Baker, you are saying is——

Mr. BAKER. It taxes it.

Mr. SANTORUM [continuing]. It taxes our technology and, not only that, but what you have said that this will move our R&D offshore.

Mr. BAKER. Right, because you need to preserve those revenue streams, if we are going to continue to invest in new technology.

Mr. SANTORUM. If two-thirds of your market is offshore and that is where your growth opportunities are, you are going to move the R&D offshore, so you can——

Mr. BAKER. You would tend to move the R&D offshore and also you would tend not to remit as many dividends back to the United States.

Mr. SANTORUM. That brings up a question Mr. Principato talks about, which is you mentioned converting royalties into dividends. I am not too sure I understand how that would affect the tax situation.

Mr. PRINCIPATO. You should understand, in the first place, business people who have integrated business operations see the funds coming back into the United States as just funds coming back into the United States, dividends or royalties, the tax side of that.

Mr. SANTORUM. Right.

Mr. PRINCIPATO. When a business looks at these funds coming in, it is fairly easy, especially if you want to get into 42, to reduce the amount of royalties that you receive, just analytically, and increase the amount of dividend flows, you get the same amount of tax.

Mr. SANTORUM. So you are just talking about accounting gains?

Mr. PRINCIPATO. No, I'm not, I am talking about how the tax rules work.

Mr. SANTORUM. I am not too sure I am following you, but I will pass on that.

One other thing I did want to mention and that is the issue of runaway plants. You are saying this doesn't get to it, this doesn't solve it. Is there anything that you see in any of these proposals that addresses that problem, or is there something that you would suggest that this committee could look at as a way of addressing that issue, if in fact you see it as an issue?

Mr. BAKER. I don't see anything really in this proposal that deals with that issue at all. You know, it has been said that this deals with it, but it doesn't really come close to making any differences.

We operate abroad, because that is the only way we can serve those customers. We just cannot reach certain customers by exporting from the United States. Penalizing the royalty flows back into the United States for the technology that those overseas companies utilize just does not deal with the issue that we are talking about, runaway plants.

Mr. PRINCIPATO. I would like to say just for a second, if I may, that runaway plant legislation should say first runaway plants are this, and then the second part of the legislation would be if you have this, the tax result would be such; not we are opposed to runaway plants, therefore, if you get royalties, there is going to be such and such a tax impact. There is no connection there.

Mr. KOPETSKI. Mr. Houghton may inquire.

Mr. HOUGHTON. One comment and one question: I think we have got to be awfully careful, Mr. Chairman and other members of this committee, how we talk about offsets. Just like the fellow who comes and steals your coat, and you say, hey, that's not right, and the fellow says, well, I'm cold and what else are you going to give me? Well, that is his problem. It is not ours, and we should not have done this in the first place.

I think what we are talking about here really is trying to create the right balance between tax policy and competitiveness, so that American industry continues to grow and thrive and do all those nice and good things that we want, namely, to increase investment and to produce more jobs.

I would like to ask Mr. Pepper, would you like to elaborate a little bit on this competitiveness issue? You know, we have talked about the numbers and we have talked about moving research and things like that. Have you got anything else you would like to add on this issue?

Mr. PEPPER. Well, let me comment on the kinds of things we would have to do, if this went through, to try to improve the bottom line. First of all, none of these things we want to do.

We think the current policy is fair, in the sense that the taxes we are paying on foreign source income are, if anything, a bit higher than on U.S. income. We have studied our competitors, and our tax rates are somewhat higher than theirs are on foreign source income, and I deeply believe that the current system drives the right behavior, that is, it encourages us to keep jobs here.

We have half of our business now offshore, but we have 70 percent of our R&D work here, our highest paid technicians here in the United States, and that is because we do get these royalty payments, because that is where we started, and we have no incentive to move outside.

If this thing went through, we would have a 9-point increase in our tax rate overnight. If we did not do something, we would be taxed at over 50 percent on our foreign dividends, over 50 percent. None of our competitors would face that. There is no way we could price for it. The only thing we could do is cut costs, unless we were to lose share, lose revenues and have to cut down plants and jobs.

How would we do that? There are really only two things we could see doing: One would be over time, you would not do this overnight, over time, without the incentive for the jobs here in R&D, you would be seeking out other opportunities for R&D activity outside this country where you would be getting better tax deductions. Again, you would not do it overnight in a crazy fashion, but we would have to look at such scenarios.

The other thing we would do, and this we would do very quickly, is look at cutting down, as has been said, on our dividend income into this country, especially in high tax rate countries like from

Japan, where we are doing well, and we would be cutting back on royalty payments. And we estimate that within 12 months we would probably cut 25 percent out of our revenue back into this country.

Now, we don't want to do that. It is not good for the country and it does not make sense for us, but this is the type of thing that we would have to do in order to try to remain competitive.

Finally, I have got to say to you that, in my judgment, the revenue that is being estimated from this, I would be dumbfounded if, after a period of 18 months, it was any more than half of what is being estimated, because companies will be forced to restructure the way they operate, and to restructure in a way that is inimical to the best interests of this country.

That is why I feel such a passion about being able to get the facts on this out to people, so that we can look at it and find another way to get this revenue.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Mr. KOPETSKI. Mr. Hoagland may inquire.

Mr. HOAGLAND. I will pass, Mr. Chairman. Thank you.

Mr. KOPETSKI. Mr. Camp may inquire.

Mr. CAMP. Thank you, Mr. Chairman.

Mr. Baker, if you could just briefly summarize for me how you feel the royalty tax proposal would hurt U.S. multinational companies operating overseas.

Mr. BAKER. Well, it would significantly reduce the net cash flows back to our U.S.-based R&D activities, because the royalties taken out of the overall basket, which permits us to offset foreign taxes against that royalty income, would now be taxed directly, and we would end up with a significantly unrecovered tax burden.

In our particular company's case, and it varies from company to company, we would see the royalty taxes on foreign source income go up by 20 points, from about 34 percent now to some 54 percent. Reduction in the cashflows to all of these major corporations in the United States would directly impact upon the amount of money that they would have available to invest in the development and creation of new products, so you would see a diminution of R&D activities.

Now, to offset that, as Mr. Pepper said, you would try to offset that legalized reduction by moving over time your research and development overseas, where it would be treated more favorably. You would reduce the amount of dividend flows back from overseas operations, because you would not be getting a tax credit adjustment for those flows. Both of those things work against the best interests of the United States.

In our case, we get about 40 percent of our revenues from abroad, but 97 percent of our research and development is done in this country today. I think those kinds of ratios exist for all of these major corporations that are a part of this coalition.

Mr. CAMP. Do you have any information or statistics on what this royalty provision could cost in terms of jobs in this country, U.S. jobs?

Mr. BAKER. Well, I can give you a quick estimation about that. It takes about $200,000 per job in R&D as an investment, and to support that, it takes about $150,000 a year. So if our revenues

were reduced in the order of $1 to $1.25 billion a year in this area, you could see about 10,000 R&D jobs disappear over time, and they are the kind of jobs that you really want to retain in this country.

Mr. CAMP. Those are excellent jobs.

I understand it would be a fair statement to say that this royalty provision is not justifiable, if the purpose is to end runaway plants.

Mr. BAKER. No, it is not really a connected item.

Mr. CAMP. I guess my question is, and it is probably really out of the scope of this hearing, but what do you think would be some of the ways to get at that particular public policy objective?

Mr. BAKER. You know, I really haven't thought through that question very well. I don't think I am particularly in an expert position to deal with that.

Mr. CAMP. I know that is not why you are here today.

Mr. BAKER. I think the issue that you really have to focus on is how can we help American industry to compete in the world as a whole. This proposal really runs directly counter to that, and I must say counter to everything the President himself has said he wants to see done in this country.

Mr. CAMP. Thank you very much.

Mr. KOPETSKI. Mr. Hoagland may inquire.

Mr. HOAGLAND. Gentlemen, I just have a brief question. I understand before I arrived you all indicated that we might drop the President's temporary ITC proposal and also the increase in the R&D tax credit as a way of compensating for the lost revenue.

Mr. OOSTERHUIS. It was not the R&D tax credit, I believe. It was the allocation of R&D, to change it from 100 to 64 percent.

Mr. HOAGLAND. Mr. Oosterhuis, do you have any ideas in this area of taxation involving the foreign operations of American companies?

Mr. OOSTERHUIS. Any ideas of proposals to raise revenues?

Mr. HOAGLAND. Exactly.

Mr. OOSTERHUIS. No, I really do not. To be honest with you, I think that what is required is to stand back and do a study of the whole international provisions, take the provisions that are in the bill off the table.

The bill that the chairman proposed last year, the Rostenkowski-Gradison bill, was a start in that direction, trying to study the international issues in a comprehensive manner, and I think that is what is required before you decide whether there is any area in which you might pick up some revenue, and other areas which might be adjusted that lose some revenue.

The international provisions, to be honest with you, are somewhat of a mess, and the most constructive thing this committee could do, it seems to me, is to take these provisions off the table and go back and engage in a long-term process of trying to sort them out.

Mr. HOAGLAND. Do you have estimates as to what the revenue loss would be, if we were to follow your recommendations on both of these areas?

Mr. OOSTERHUIS. The royalty proposal is about $1.8 billion, and the deferral proposal is about $700 million over 5 years, so I guess it is about $2.5 billion.

Mr. HOAGLAND. OK.

Mr. PEPPER. We talked before you came in about the investment tax credit in our view not being a good return for the money.

Mr. OOSTERHUIS. And that is about $12 billion over 5 years.

Mr. PEPPER. We do feel there is a real issue about rates, of which we haven't talked, going up the full two points I think is very problematic. Again, I would weigh that against the investment tax credit.

Mr. OOSTERHUIS. Exactly.

Mr. PEPPER. I would forego the investment tax credit to keep the rates down.

Mr. HOAGLAND. Mr. Pepper, you are talking about the temporary ITC for companies with over $5 million?

Mr. PEPPER. Right.

Mr. HOAGLAND. Do you all have any opinion with respect to the permanent ITC for companies of under $5 million?

Mr. PEPPER. The small business, you mean?

Mr. HOAGLAND. Right.

Mr. PEPPER. I really should not talk to that, I don't think, but I am very clear on the ones for our business. I am making investment decisions every day, and the existence of a 7-percent investment tax credit on top of that will not move those decisions, and it is only attached to hard assets and is really dealing with a small part of the pie. It is not a productive way to invest scarce dollars versus rates or these other things that would really move against our basic interests.

Mr. HOAGLAND. I am sure you know, Mr. Pepper, we got some very astute advice from the chairman of your executive committee recently at a committee seminar, Mr. Smale. He made many of these same points.

Thank you, Mr. Chairman.

Mr. KOPETSKI. Mr. Pepper, I would like a quick followup. You were talking about these priorities on the taxes. Let me ask you, Mr. Baker and Mr. Principato which is more important to you, the royalty issue or the corporate tax increase?

Mr. PEPPER. The royalty issue.

Mr. BAKER. Yes, I would agree with that, too.

Mr. PRINCIPATO. Absolutely.

Mr. PEPPER. The reason the royalty issue is so important is that it is so pointed at a small group of technically based companies, and there is no way it could be recovered. A corporate rate increase is much broader based. In saying that, let me add that I would be working to put together a budget that would allow us not to have to go up that full amount and take it out of somewhere else, and I have mentioned some of those already.

Mr. KOPETSKI. Thank you all very much. It has been a very informative testimony.

We will call our next panel, and if you could make this a quiet and orderly transition, that would help a little bit. We have John Young, from Hewlett-Packard Co., Palo Alto, former president and CEO; Dan Bucks, executive director of the Multistate Tax Commission; Oliver Smoot, executive vice president, Computer & Business Equipment Manufacturers Association; from the American Electronics Association, we have Robert DeHaven, chairman, National Competitiveness Committee; and from the Electronic Industries As-

sociation, Mr. William A. Warren, vice president, tax, who is from TRW, Inc., of Cleveland, OH.

Thank you, gentlemen. Mr. Young, if you would like to begin this panel's testimony.

STATEMENT OF JOHN YOUNG, FORMER PRESIDENT AND CHIEF EXECUTIVE OFFICER, HEWLETT-PACKARD CO., PALO ALTO, CA

Mr. YOUNG. Thank you, Mr. Chairman.

My name is John Young, and I retired as president and CEO of Hewlett-Packard on October 31 of last year.

I certainly support the overall direction the President is taking in an aggressive stance to reduce the deficit and putting together an economic package that begins to also recognize the need for essential new public investment, and that is a tough balancing act.

It is important that all taxpayers, including corporate America, pay their fair share of the burden of reducing the deficit, and certainly that is a starting point that Hewlett-Packard takes. Yet, you and the Congress have the task of working with the administration to design the final package, and I hope that at the margin some genuine improvements can be made.

In fact, I am really ending up seconding a lot of what you have just heard from the prior panel, because I, too, am concerned by those international tax provisions, the treatment of deferrals and royalties as passive income for foreign tax purposes.

Like the prior testimony, certainly we understand that there are legitimate concerns about the runaway plant issue and so forth, but we certainly, at least in our industry, do not identify either of these proposals as being responsive to that basic need. It has the unintended consequence of actually having a fairly significant impact on the high-technology base of this country.

In effect, the approach, just as you have heard, in this industry, as well, I suspect will have the unintended effect of driving investments and jobs offshore, just the opposite of what you would hope for.

In virtually all cases in the high-technology business, companies locate operations abroad for genuine business reasons and not primarily for tax reasons. That could not be more than fifth or sixth on the list. U.S. firms often decide to locate production operations within the European Community, for example, because of tariff barriers or local manufacturing environments or to have an important market presence. So ending tax deferral on that really will not bring home to the United States those European operations. So the extent that the tax law fixes business decisions, the approach would actually encourage the movement of facilities away from the United States.

U.S. firms usually locate in the United States their high-quality supervisory, administrative and engineering jobs that support this kind of foreign expansion. In Hewlett-Packard's case, for example, over the last 10 years, their revenues have grown by a factor of four, from $4 to $16 billion. Their R&D has grown by a factor of four, $400 million to $1.6 billion. And their exports have grown by a factor of four, from $1 to $4 billion over this period of time.

Now, it has ended up that a lot of that growth has been outside the United States. In fact, in 1992, 55 percent of all the orders came from outside the United States, but 85 percent of that $1.6 billion in R&D is done inside the United States, and that is what generates that $4 billion in exports.

The jobs kept here are the high-skilled, high-wage jobs that Americans are uniquely qualified to fill. But companies like Hewlett-Packard cannot continue to grow the number of Americans employed as we currently do, without being successful abroad, and, as such, any cutback on deferral will reduce the profitability and eventually the market share of U.S.-based firms, which will impede the exports from abroad.

Another undesirable feature of this deferral provision is that it singles out U.S.-based firms, while foreign competitors continue to enjoy not only the benefits of deferral by their home countries, but often get tax sparing provisions, as business profits are remitted.

The second proposal, you have heard a lot about royalties as passive income. Again, this substantially negates the 1977 R&D tax regulations that gave rise out of 861 to allocating R&D expense to foreign source income. We also would agree that going back to the 64 percent regulatory compromise that the Congress asked Treasury to adopt last year really accomplishes very well what I think is a balance between these competing forces.

Now, if the committee is genuinely concerned about the runaway plant issues, and perhaps you should be, we would strongly suggest crafting some more tightly focused legislation that applies both to United States-and foreign-based companies—these proposals again wouldn't apply to a foreign-owned corporation leaving the United States—to be sure that all sides of the equation are treated equally.

We think any approach to address the runaway plant problem which targets only companies that close down domestic plants would be far superior to that in the proposed legislation. Then we have some ideas on how to do that in a practical sense.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF JOHN YOUNG,

FORMER PRESIDENT AND CEO FOR HEWLETT-PACKARD COMPANY

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

April 1, 1993

Mr. Chairman and Members of the Committee. My name is John Young and I retired as President and CEO of Hewlett-Packard Company last November 1. During the last 10 years, HP grew its net revenues from $4.2 billion to $16.4 billion; R&D grew from $424 million to $1.6 billion, and exports from the U.S. grew from $2.3 billion to over $4.0 billion.

I want to thank this Committee for extending these hearings to accommodate those of us in the business community who desire to share our views regarding the Administration's tax package. As you know, I supported President Clinton in his bid for the Presidency last Fall. I believe in the direction in which he is taking our country. I believe in the overall approach that the Administration's package takes to reduce the deficit and to begin essential new public investment.

It is important that all taxpayers, including corporate America, share in the burden of reducing the deficit. I recall in 1990 that Chairman Rostenkowski proposed a freeze in domestic programs and the application of the peace dividend to deficit reduction. I noted then that this action was a very brave move which I supported. We need similar courage to support the President's initiatives today. It is difficult to reduce the level of services provided by government. Yet, Congress still has a role in working with the Administration in order to improve the package at the margin.

In particular, I am concerned by two of the international tax provisions: the cut-back on deferral and the treatment of royalties as passive income for foreign tax credit purposes. I understand these provisions were included in the package to prevent the movement of U.S. plants offshore. While that goal is certainly laudable, the approach is analogous to a surgeon using an ax rather than a scaple. These two international provisions do more than simply target companies moving plants abroad. They negatively impact all U.S.-based companies that do business overseas. This result is particularly damaging since the proposals have <u>no impact</u> on our foreign-based competition. Moreover, just as in my surgeon using an ax analogy, the ultimate goal of discouraging runaway plants will not be achieved by these proposals. In fact, the provisions actually could have the reverse effect and provide an even greater tax incentive for <u>foreign</u> expansion.

If the government truly wishes to address runaway plants, it should not use an ax. Rather it should use a more targeted approach tied to actual behavior of companies.

My testimony today will cover the deferral cutback provision and its anti-competitive impact and the royalty issue.

I. IMPACT OF TAX DEFERRAL ON COMPETITIVENESS

A. Companies Base Plant Location Decisions on Business Factors.

In virtually all cases, companies locate operations abroad for business reasons and not for tax reasons. For example, U.S. firms often decide to locate production operations within the European Community ("EC") to avoid significant tariffs and to satisfy the market requirement that products purchased be manufactured within the EC. Market presence considerations which include localization of products to local language and cultural needs, servicing and installation of products, are the most important driver for our overseas expansion. Other business reasons for locating manufacturing offshore include lower transportation costs and lower wage rates. Once a company decides it wants to expand and sell its products competitively to the EC market, then tax climates of the potential countries within the EC are considered in choosing the location, much like corporations compare tax rates among our 50 states when choosing a location within the U.S.

Because tax deferral does not drive firms to move plants abroad, ending tax deferral for a portion of the income earned abroad will not cause these firms to stop expanding their international operations or to move plants back to the United States, although it may make foreign expansion difficult and may slow down the process relative to our competitors.

B. Foreign Investment Creates U.S. Jobs.

High quality supervisory, administrative and engineering jobs that support foreign expansion are usually located in the United States when the multinational is U.S.-based. Hewlett-Packard is a typical example. For HP's fiscal year ending in 1992, 55% of our orders were from customers outside the U.S., yet 85% of HP's R&D was performed within the U.S. HP's overseas managers like to point out that most of HP's administrative and manager positions are located in the United States as well. The jobs we keep here and hope to continue to keep here are the high skilled high wage jobs that Americans are uniquely qualified to fill. But companies like Hewlett-Packard cannot continue to keep the number of Americans employed as we currently do without being successful abroad.

U.S. based companies in high tech, like HP, have an interesting progression regarding overseas investment. In order to increase overseas sales, you first need a distribution and sales presence. As business expands, you grow localization activities, then assembly and manufacturing activities, and finally R&D activities. All of these activities need to mature to support a large presence in the U.S. and continue to increase your export volume from the U.S. Any cutback in deferral will reduce the profitability and market share of U.S.-based firms, which will impede exports from the United States.

C. The Proposal Singles out U.S.-Based Firms.

Perhaps the worst feature of any cutback in deferral is that it singles out U.S.-based firms, while our foreign competitors continue to enjoy not only the benefits of deferral given by their home countries, but often even get tax sparing on active income earned outside of their home countries. Cutting back on deferral will substantially increase the tax costs of U.S.-based firms compared to that of our foreign competitors, further widening the competitiveness gap. The primary beneficiaries of this change therefore will be foreign-based multinationals, which do not necessarily center their high paying jobs in the U.S. as U.S.-based firms do. Therefore, it is very much in this nation's interest to ensure at a minimum that the playing field is level. This cut-back in deferral is clearly a giant step in the wrong direction.

D. The Administration's Proposal to Cutback Deferral.

Hewlett-Packard belongs to the Deferral Preservation Coalition that testified on the last panel on the technical tax policy problems associated with the specific cut back on deferral that was included in the Administration's package. I do not want to reiterate all that has just been said on that subject.

I want to discuss the business realities associated with the underlying premise of the Administration's proposal. We are not keeping our accumulated income overseas to avoid paying tax. The shareholders of publicly held companies would simply not accept a permanent build up of large cash amounts offshore. Nor does the U.S. tax law permit a tax-free permanent build-up of significant earnings. Indeed, the PFIC rules already put an end to cash build ups at 50 percent of total assets. To the extent cash below that 50% level is kept offshore, it is generally for the purpose of accumulating enough funds to allow for the next business expansion.

I'll give you a very basic example to illustrate. If a company has a foreign facility that cost $100 million to build, in all likelihood, it will take more than $100 million to build its next facility in another foreign country. It will take a while to accumulate the $100 million, and the 25% limit on a tax-free build-up appears on its face to be very inadequate to permit a reasonable accumulation of these funds over time.

Accordingly, if the Congress is concerned that the current PFIC rules are inadequate, I believe that additional study would be required before corrective legislation is enacted. In this regard, it should be noted that our foreign competitors are not subject to the U.S. PFIC rules, so additional restrictions in this regard clearly discriminate against U.S. companies in the critical area of financing future expansion.

E. The Provision Could Actually Promote Runaway Plants.

Because companies do not make the decision to operate offshore for tax reasons, changing the tax consequences of those decisions will not bring foreign facilities back to the United States. If anything, this provi-

sion actually encourages firms to expand overseas when they otherwise might expand domestically.

If the goal of the Administration is to discourage runaway plants, the proposal adopted should be targeted only at companies moving operations from the U.S. to overseas locations, it should affect all such companies regardless of where they are based, and it should at a minimum have the effect of discouraging such movement. This cutback in deferral satisfies none of these criteria. It completely fails to target foreign-based firms who can also move facilities offshore. At the same time, it severely penalizes firms who are not moving U.S. jobs abroad, but who are expanding overseas so as to bolster their U.S. employment. And finally, it could actually have the effect of encouraging further offshore movement.

II. IMPACT OF PASSIVE CHARACTERIZATION OF ROYALTIES ON COMPETITIVENESS

A. The Provision Targets High Technology Companies.

By treating royalties as passive income, the Administration's proposal eliminates the ability to treat within the same basket of income the royalties and manufacturing profits from the same foreign business operation. It only targets certain industries, however. It does not go after industries that can rent their products. It does not go after companies that debt finance their foreign expansion. Rather, it targets the model of the high technology company that conducts R&D in the United States and licenses it offshore.

B. The Provision is Non-Competitive.

It should be pointed out that many of our competitors are based in countries which do not penalize their R&D performers in this way. Many of our competitors are based in countries with tax systems like France, which allows a 100 percent R&D deduction and taxes royalty income earned overseas, but does so at a very low rate. These countries recognize the importance of having their multinationals perform R&D locally and license the results around the world. In order to compete better against our competitors based in these countries, we should be given the opportunity to play on a level playing field.

C. The Proposal Could Actually Promote Runaway R&D Facilities.

Just like the deferral cutback proposal, the royalty proposal will fail to accomplish its stated goal. Rather than encouraging U.S. firms to bring their manufacturing operations back to the United States, to the extent companies are motivated by tax considerations, this proposal actually could encourage firms to move their R&D operations off-shore to be combined with their manufacturing facility.

Once again the proposal fails to target the behavior it seeks to discourage, but instead attacks all companies in the R&D business. Once again the proposal

fails to address foreign-based firms who move operations offshore.

D. The 64% Compromise Solution Should Be Permanently Adopted

The proposal would achieve a result that is substantially worse than that produced under the 1977 regulations which first gave rise to the allocation problem. Those regulations, by penalizing U.S. performed R&D, put our industry in a very difficult position vis-a-vis our competitors. We had hoped that the 64% compromise regulation solution finally proposed last year by the Congress would resolve the problem once and for all. We hope in the end that is the approach that both Congress and the Administration take to resolve this issue.

III. A RUNAWAY PLANT ALTERNATIVE

If we want to surgically work on the runaway plant problem, we should craft a legislation which: first applies to both U.S. and foreign owned operations which have facilities within the U.S.; second, applies when corresponding jobs are increased abroad at the expense to jobs in the U.S.; and third, results in actually creating an effective disincentive for inappropriate corporate behavior.

IV. CONCLUSION.

In sum, we believe any approach taken to address the runaway plant problem which targets only companies that close or down size domestic plants would be far superior to that taken in the package. The approach is flawed not only because it adversely affects the international competitiveness of companies that refrain from closing or down sizing U.S. plants, but also because it fails to apply any similar pressure on foreign-based companies. Finally, to the extent tax law affects business decisions, this proposal would actually encourage movement of facilities away from the United States. As such, the package would be greatly improved if it did not include these two provisions.

I would be happy to answer any questions you may have.

Mr. KOPETSKI. Thank you, Mr. Young. I appreciate your testimony very much.

All the testimony of members of the panel will be made a part of the record of this hearing, as well, and I appreciate those that can summarize their testimony in about a 5-minute time period.

Mr. Young, I do want to commend you and Hewlett-Packard for your research and development activities. I know from my district that it is no accident that Hewlett-Packard is located in Corvallis, OR, it is because Oregon State University is located there and the great partnership that exists between a public university and a private corporation, with the daily interchange of ideas and activities and, therefore, it is good economics for our State that it occurs.

Mr. YOUNG. Thank you.

Mr. KOPETSKI. Mr. Bucks, welcome, and we invite you to testify.

STATEMENT OF DAN R. BUCKS, EXECUTIVE DIRECTOR, MULTISTATE TAX COMMISSION

Mr. BUCKS. Thank you.

Mr. Chairman and members of the committee, thank you for this chance to testify. I am Dan Bucks, with the Multistate Tax Commission, an organization of 33 State governments. We develop State tax rules to divide the income of businesses operating across State and national boundaries, and we also have real world experience auditing corporations for taxes.

During his campaign, President Clinton focused attention on one of the great and unfortunate Federal policy failures of the last 30 years, the failure to require fair and proper reporting for tax purposes of income earned by global corporations within the United States.

As part of deficit reduction, President Clinton proposes to encourage taxpayers to document their international transfer prices when they file their returns. Taxpayers doing so would qualify for an exception to certain penalties. The President's penalty related proposal is a useful interim measure to reduce losses to the Federal and State treasuries. However, this proposal should not be viewed as more than an interim measure.

The administration's full strategy to solving international tax problems has as yet, we understand, to evolve. As that strategy develops, we would recommend that the Federal Government replace the failed arm's-length pricing system with a formula apportionment system. The Federal Government's approach to taxing global corporations is a failure, and it is time to recognize that the emperor has no clothes and is in dire need of being saved from his own embarrassment.

The Federal Government is wearing an imaginary suit of clothes called arm's-length pricing adjustments. This method is largely unworkable and wastes scarce public and private resources. Worse yet, it fails to collect the tax revenue that is intended and causes real economic harm by shifting the tax burden unfairly to small businesses that are the real engine of job growth in America.

States care about this issue, because for every dollar that the Federal Government loses because of its failure to solve the international transfer pricing problem, the States lose 22 cents. In this campaign, President Clinton estimated the Federal revenue loss

from transfer pricing problems at $10 to $12 billion a year. Our analysis supports that estimate. At that rate, States are losing about $2.5 billion annually, bringing the estimated combined State and Federal revenue loss to nearly $15 billion a year.

The arm's-length pricing system has failed, because it attempts to do the impossible. The huge volume of trade between related corporations is too great to police on a transaction-by-transaction basis. More fundamentally, the arm's-length pricing method is impossible, because it assumes an economic world that simply does not exist. The method requires the IRS to discover free market prices to use as a standard to adjust the prices for the things that are exchanged in a controlled trade situation among affiliated companies. Too often, those free market prices do not exist, and so these cases deteriorate into a debate over a range of prices, any one of which could be used because there is no right answer.

As noted international tax attorney Louis Kauder described last week, the arm's-length pricing system is something like organizing an Easter egg hunt, without first hiding any eggs. No matter how many children are invited to join in the search, and no matter how detailed the instructions are for finding the eggs, none will be found, because none are out there.

Fortunately, there is a solution. It is called formula apportionment with combined reporting, a method that the States developed and that is a tried and proven success. This method completely eliminates the problem of income being shifted and taxes being avoided through transfer pricing. It would insure fair and equitable tax payments by global corporations that reasonably reflect the economic activities they conduct in the United States, and it would close the multibillion-dollar tax gap that is caused by the current failed policies, and it would also create a level playing field among businesses of all types and sizes.

A formula apportionment approach is considerably more efficient than the Federal method that is used. In fact, States spend roughly one-third to one-seventh of the time doing the same job of auditing that the Federal Government tries to do. The bottom line in all of this is that global formula apportionment works, while arm's-length pricing fails.

So why do we stick with a failed method? Treasury officials say that it is because the devil makes us do it. And who is the devil? International tax treaties. But is that a reasonable answer? No tax treaty can require us to do the impossible. In fact, the treaties do not even talk about adjusting prices. They talk about adjusting profits to an arm's-length level.

We think it is time for the Treasury Department to take the lead with our trading partners to go down a new path of dividing profits through formula apportionment, instead of sticking with the failed method of arm's-length pricing.

Thank you very much.

[The prepared statement and attachments follow:]

Statement of Dan R. Bucks

Multistate Tax Commission

Mr. Chairman, Members of the Committee, thank you for the opportunity to testify today. I am Dan Bucks, Executive Director of the Multistate Tax Commission. The Commission is an interstate organization representing 33 states.[1] One of the Commission's major activities is developing fair and administrable methods of dividing, for state tax purposes, the income of businesses operating across state and national boundaries. Our comments today concern the proposal contained in President Clinton's deficit reduction plan to strengthen the federal government's authority to achieve a fair and administrable allocation of the income of multinational corporations to the United States. That authority, of course, is vested in Section 482 of the Internal Revenue Code.

During his campaign, President Clinton focused attention on the failure of federal policies to stop tax avoidance by multinational corporations due to their transfer pricing practices. He observed correctly that whenever a group of taxpayers avoids paying their properly owed share of taxes, all other taxpayers, unfairly, have to pick up the slack. He also clearly recognized that tax avoidance by multinational businesses hurts our economy, by placing dynamic, small and medium sized businesses who are often competing with them in the same markets—but without multinational operations—at a competitive disadvantage.

In drawing attention to the transfer pricing issue in the campaign, President Clinton was following the trail blazed by members of this Committee. The Commission commends Representative Pickle, in particular, for the exceedingly thorough hearings he held in 1990 and again last year on transfer pricing and the federal government's administration of Section 482. The Commission also strongly commends the inclusion in Section 603 of Chairman Rostenkowski's "Foreign Income Tax Rationalization and Simplification Act of 1992" of a mandated federal study of global formula apportionment as an alternative to the current arm's-length pricing system. Formula apportionment will be a major focus of our testimony today.

Why are state government representatives concerned about the transfer pricing issue? Very simply, because for every dollar that the federal government loses because of improper transfer prices, states—whose tax systems are now largely tied to the federal determination of U.S.-source income—lose 22 cents.[2] If the federal government is losing $10-12 billion annually, as President Clinton suggested during the campaign,[3] that means that the states are losing an **additional** $2-2.5 billion. This brings the combined government revenue losses from transfer pricing to $15 billion annually.

The Commission shares President Clinton and this Committee's concerns that improper transfer prices are causing a serious drain on the federal treasury. MTC staff research suggests that $10-12 billion in annual losses is a realistic, if not conservative, estimate. Looking at just one category of transactions by one group of multinational businesses illustrates this. IRS data have consistently shown that foreign-owned wholesalers and retailers—many of which act as distributors for affiliated foreign manufacturers—pay considerably more for the goods they resell than do U.S.-owned wholesalers and retailers. If they had had the 76 percent cost-of-goods sold to sales ratio of their U.S.-owned competitors rather than the 85 percent rate they reported,[4] their 1989 taxable incomes would have been $35 billion higher. All other things equal, they would have paid $12 billion more in tax at the statutory 34 percent tax rate. Just this simple "back-of-the-envelope" calculation addressing **just one category** of multinational corporations can, in other words, suggest an annual revenue loss attributable to transfer pricing that is very close to President Clinton's campaign estimates.

Another way that a $10-12 billion annual revenue loss can be substantiated is by comparing it to the total volume of transactions between related corporations that cross the U.S. border each year. A conservative estimate involving some extrapolation of IRS data is $350 billion.[5] At this volume, transfer prices that are

"off" on average by just 10 percent would again lead to an understatement of U.S. taxable income of $35 billion and underpayment of tax of $12 billion. This is not to assert that this is the average variance of actual transfer prices from "arm's-length" prices. It is not an implausible variation, however, given that penalties do not even potentially apply until inbound transfer prices are 100 percent too high and outbound transfer prices are 50 percent too low. It is also plausible that taxpayers would take an "aggressive" transfer pricing position to the extent of a 10 percent variance when there is no certainty concerning the true "arm's-length" price in any case and when the IRS has had such little success at sustaining its transfer price adjustments when they are appealed and litigated.

As part of his deficit reduction package, President Clinton proposes to clarify the statutory authority to implement proposed regulations issued by the IRS in January relating to the imposition of penalties when the IRS makes substantial adjustments to transfer prices. Under current law, two different levels of penalties may apply if an IRS auditor's transfer pricing adjustment is sustained through the appeals process and, if need be, the courts. The level of penalty depends upon how large the adjustments are in percentage terms and/or in total dollars. Some penalties may be avoided, however, if the taxpayer made a reasonable effort to determine the proper transfer prices and if the taxpayer reasonably believed that its transfer pricing methodology achieved an "arm's-length" result.

The purpose of the new regulations is to encourage taxpayers to set transfer prices through a deliberate and documented process established by legal and economic experts **before** tax returns incorporating them are filed. The **mechanism** to achieve this is foreclosing the "reasonable cause and good faith" exception to the penalties for taxpayers who do **not** establish and document transfer pricing practices in advance. No more will taxpayers be able to play "audit roulette" secure in the knowledge that should they be one of the unlucky few receiving a Section 482 assessment at the end of an audit, they can **then** expend the resources to hire the accountants, economists and attorneys to defend either their original transfer prices or other transfer prices leading to a smaller assessment. This strategy, should they lose, will now have a significant penalty cost.

The President's penalty-related proposal is a useful and necessary interim measure to minimize the losses to the federal and state treasuries that flow from the fact that nothing in Section 482 compels taxpayers to establish arm's-length transfer prices. However, we believe that the arm's-length pricing system has failed and needs to be replaced. The Administration's full strategy in approaching international tax problems is still, as we understand it, evolving. As that strategy develops, we would recommend that the federal government move actively to replace the failed arm's-length pricing system with a formula apportionment system.

Why has the arm's-length pricing system failed? Because it attempts to do the impossible. It tries to regulate the prices for every category of product, service or intangible asset exchanged between related, jointly owned and controlled corporations. There are more than 46,000 global corporations doing business in the U.S. that operate with and through affiliated corporations in foreign countries.[6] These corporations engage in $350 billion of transactions within their own family of related corporations in foreign nations every year.[7] This amount of controlled trade represents an enormous volume of transactions, and the amount of resources required to audit and adjust the prices for this volume of trade is overwhelming and well beyond even the recently expanded resources of the IRS.

Beyond the sheer volume of controlled transactions, there is the more fundamental problem that the arm's-length pricing method assumes an economic world that does not exist. Trade among jointly owned corporations is not, by definition, arm's-length, free market trade. So the IRS must attempt to discover free market prices for comparable transactions as a standard to adjust the prices in the

controlled trade situation. The problem is that for major global industries—such as pharmaceuticals, automobiles, financial services, and electronics—there are frequently no international free market transactions to compare with the controlled trade among affiliated companies. As Louis Kauder, an international tax expert, testified before the Senate Governmental Affairs Committee last week, attempting to enforce the arm's-length pricing system under these circumstances is "something like organizing an Easter egg hunt without first hiding any eggs. No matter how many children are invited to join in the search, and no matter how detailed the instructions are for finding the eggs, none will be found because none are out there."[8]

The fundamental problem of the absence of comparable uncontrolled transactions is illustrated by one of the famous cases the IRS lost: the Bausch & Lomb case. Bausch & Lomb licensed the use of a patent on a unique manufacturing process for soft contact lenses to its Irish subsidiary. The principal tax dispute was over whether or not the amount of royalty paid by the Irish subsidiary to its parent was sufficient. The IRS tried to raise the royalty price being paid, but the problem is that there is no free market price for patents in soft contact lens manufacturing processes. Absent a free market for this asset, the IRS could not prove that its assessment was correct. The case deteriorated, as most such cases do, into a debate over a range of prices, any one of which could be used because there is no single right answer.

Worse yet, unlike the typical case in which a taxpayer has the burden of proof to justify his or her method of reporting income, in the arm's-length world, the IRS, for all practical purposes, must shoulder the burden of proof. The IRS must prove, not only that the taxpayer's reported prices are incorrect, but what the correct prices are. Again, in the big-dollar cases involving valuable intangible assets, this is an impossible task because free market prices necessary for the IRS to prove the taxpayer wrong often do not exist.

Even in more routine cases involving widely sold consumer products, like VCRs or motorcycles, very complicated and subjective adjustments for "volume discounts", "location savings", "market risks", "market penetration strategies", and other economically relevant factors may have to be made. But every such adjustment adds a potentially disputable issue, and any number of prices within a broad range may end up being correct. Because the burden of proof has effectively been turned on its head, the global taxpayer has wide discretion to report what it wishes to various national tax authorities. The arm's-length system thus fails the first test of a tax system, namely that it be mandatory. Because it is based on a false economic premise and is flawed by a misplaced burden of proof, the arm's-length method is more like a voluntary contribution system than a real system of taxation.

The American states confronted the fundamental issues involved in dividing the income of multijurisdictional corporations much earlier than the federal government, because there was significant interstate commerce between related corporations long before there was significant international commerce. The states recognized very early on the practical impossibility of preventing improper income shifting on a transaction-by-transaction basis.

More importantly the states recognized the full range of economic synergies involved in being an integrated economic enterprise that make it theoretically impossible to identify where profit is earned. Jointly owned and controlled corporations that operate together on a global basis benefit from economies of scale, the ability to minimize risk, and the fact that technical expertise and information can often be obtained more cost effectively when it is fixed in the minds of employees than when it has to be purchased on the open market. These kinds of efficiencies generate value for the whole enterprise that is greater than the sum of the parts, and it is this value that cannot meaningfully be divided among separate legal entities as

the arm's-length system attempts to do. In choosing formula apportionment of the combined income of all the members constituting an integrated economic enterprise over the current separate entity, arm's-length, transactional approach, the states were thus choosing a system that the "economic theory of the multinational firm" is only now catching up to. Formula apportionment is the method of tax accounting that best fits the economic reality of world trade conducted within global enterprises. It should also be emphasized that formula apportionment is a mandatory taxpayer reporting system, not an after-the-fact income reallocation system like Section 482.

A growing number of international tax experts have either flatly endorsed substituting a combined reporting formula apportionment system for the current arm's-length system, or suggested that the option be seriously considered. Among these experts are Ronald Pearlman, former staff director of the Joint Committee on Taxation, economist Lawrence Summers, President Clinton's nominee to be Undersecretary of the Treasury for International Affairs, and attorneys Stanley Langbein, Michael McIntyre, Louis Kauder, Dale Wickham, and Charles Kerester.[9]

Under a combined reporting, formula apportionment system, the legal entities comprising a distinct and integrated economic enterprise are first identified. For example, if a group of commonly owned corporations is really engaged in two separate businesses, say, steel manufacturing and a department store chain, and there are no significant economic ties between the two businesses, then the income of the two separate businesses is apportioned separately.

Next, the combined income of the business is determined in a manner similar to the calculation of federal consolidated income, with the key factor being the elimination of intercompany transactions. Returning to the example, assume that the parent company of the department stores is a wholesaler. Further assume that it purchases all inventory from unrelated suppliers. It then resells most of the inventory to the related department stores incorporated separately in each state, and some of it to unrelated department stores. In this case, the charges from the wholesaler to the related retail stores would be eliminated. The business' combined income would be calculated by taking the total of the department stores' retail sales and the wholesaler's sales to independent department stores, and subtracting from it the wholesaler's inventory purchases and all other expenses paid by both the wholesaler and its related department stores to unrelated suppliers (e.g., rent, interest, wages).

Finally, the combined income is apportioned to each state with legal jurisdiction to tax a share of it in proportion to objective measures of the activities engaged in by the business in each state. The most commonly-used measures are property, payroll, and sales, and the apportionment is usually done on an equally weighted basis. Thus, if 10 percent of the business' sales to outsiders occurred in State A and 10 percent of its payroll and property were located there, State A would be able to tax 10 percent of the business' combined income.

California, Montana, North Dakota, and Alaska continue to require multinational businesses to do this combination and apportionment on a global basis (although they generally permit an election to include only corporations incorporated in or with most of their business in the United States). The federal government could adopt the same global apportionment system and thereby eliminate any need to examine or indeed worry about intercompany transfer prices.

As in all tax systems, there are complexities to work out and policy choices to be made. For example, an overall functional examination of a multinational corporate group needs to be made to determine whether it is engaged in one or multiple lines of business, and, if the latter, to determine which subsidiaries are involved in which business. But this is a far simpler matter than engaging in a functional analysis for transfer pricing purposes, which may require not only the

determination, but also precise measurement, of which of two parties to a particular transaction contributed which assets, incurred which expenses, and bore which risks. The inevitable conclusion, however, is that the range of potential controversies between taxpayers and tax authorities is exponentially larger under a transaction-based transfer pricing enforcement system than it is under formula apportionment.

Many "red herrings" are pulled out of the barrel when a federal apportionment option is discussed. Addressing the objections raised to formula apportionment is beyond the scope of this hearing and this statement. To give one example, however, it should be clear that is far simpler to translate into dollars the annual net income of an entire subsidiary than it is to determine which of two parties in a cross-border transaction is actually bearing foreign exchange risk and then to value this for pricing purposes.

From the standpoint of the resources required to enforce it effectively, formula apportionment beats a system based on adjusting transfer prices hands down. A comparison of the amount of staff time required by the federal arm's-length method and formula apportionment is shown on the chart accompanying this testimony. The federal government spends at least three to seven times as many staff hours completing an international arm's-length audit that may cover only a small portion of a company's related-party transactions as compared to the hours the states spend on an international formula apportionment audit that covers all international issues. This comparison actually understates the greater efficiency of the states' approach, because a "best case" scenario for arm's-length reported in a joint 1992 Treasury/IRS report[10] is being compared to the "worst case" scenario of the states.

Does using three to seven times as much staff time as the states yield better results? Sadly, the answer is "no." The Internal Revenue Service has failed to sustain its transfer pricing adjustment in every major case it has taken to court in the last ten years. Losing badly in court, the IRS has turned to settling a large portion of transfer pricing cases, and in 1991 it settled those cases for an average 23 cents to 28 cents on the dollar.[11] These are not intended as criticisms of the IRS, for it has dedicated and talented staff working on these issues. The problem is that the arm's-length pricing system largely impedes success. The fault lies with the policy, not with the Service. But in comparison, the states have won the bulk of their international cases, and the U.S. Supreme Court has upheld the validity and fairness of their formula apportionment method.[12]

It should not be overlooked that states that are among the smallest in the nation, such as North Dakota and Montana, have succeeded in administering the international apportionment system when the federal government has failed to make arm's-length pricing work. Sadly, the Reagan Administration in the mid-1980's pressured these and other states to limit their use of international apportionment.

So what is our current situation? We have an approach to international taxation that loses the federal and state governments a conservatively estimated $15 billion a year, that shifts that cost unfairly to ordinary taxpayers and small businesses and costs the federal government three to seven times the staff resources as compared to the more efficient and more effective state system of formula apportionment. It is an approach under which the IRS has not been able to win a major court case in recent times, and it must settle other cases for a minor fraction of the original assessments. It is an approach that is doomed to fail because of the volume of transactions that must be reviewed and corrected and, more fundamentally, because the approach does not fit with the economic realities that lead to the formation of multinational corporations in the first place.

Why do we stick with a method that has failed so badly for nearly 30 years? The reason given time and again by Treasury officials is that the "Devil makes us do it." Who is the Devil in this case? International tax treaties. But is this a

reasonable answer? No treaty and no law should require anyone to do that which is impossible. If they do, they should be changed. Further, the major treaties do not speak of adjusting prices to an arm's-length level. In fact, the treaties speak of adjusting profits in a manner that achieves arm's-length results[13] Treasury could, if it so decided and without revising the treaties, explore with other treaty partners developing formula apportionment processes that adjust profits rather than prices. Thirty years ago, the U.S. government led its trading partners down the arm's-length pricing path. We now know that path has reached a dead end, and it is time for the U.S. government, through Treasury, to lead its trading partners down a new path of dividing profits through formula apportionment.

Mr. Chairman and Members of the committee, we believe that in continuing to seek cover from transfer pricing problems in Section 482, the federal government is in fact parading naked in the international tax arena. It is time for this emperor to get a suit of clothes. He will not find a good suit of clothes in London, Brussels, Berlin or Tokyo, and he will certainly not find them in the Cayman Islands or Netherlands Antilles. The emperor will find a good suit of clothes in Sacramento, Salem, Helena, Boise and Bismarck. And when he finds this suit of clothes, he will discover that they fit well, are a good value for the money, and will last a long, long time. The Multistate Tax Commission urges the Committee to give serious consideration to the formula apportionment alternative to Section 482. As you move to implement President Clinton's transfer pricing penalty-related provision—and we support this as a necessary emergency measure—we also urge you to hasten the transition from a failed arm's-length pricing system to international formula apportionment.

Thank you.

ENDNOTES

1. The Member States of the Multistate Tax Commission are Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington.

   The Associate Member States are Alabama, Arizona, Connecticut, Georgia, Louisiana, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee, and West Virginia.

2. Multistate Tax Commission staff estimate based on a calculation of the weighted average state statutory corporate income tax rate as a percentage of the federal statutory rate.

3. Governor Bill Clinton, Putting People First, A National Economic Strategy for America, p. 22. The revenue to be gained by stepped-up enforcement of Section 482 is estimated there as growing from $9.0 billion in 1993 to $13.5 billion in 1997. The four-year average is $11.3 billion.

4. James R. Hobbs, "Domestic Corporations Controlled by Foreign Persons, 1989," Statistics of Income Bulletin, Winter 1992-93, p. 12, Figure F.

5. With regard to U.S. subsidiaries of foreign parent multinationals, the IRS Statistics of Income Division has only compiled the data on transactions with related parties for the 121 foreign-controlled U.S. corporations with over $1 billion in sales. The IRS reports a total of $89 billion inbound and outbound transactions for this group of companies, exclusive of the principal amount of loans. See: James Hobbs and John Latzy, "Transactions Between Foreign Controlled Corporations and Related Foreign Persons, 1988, Data Release," Statistics of Income Bulletin, Summer 1992, p. 122. (We exclude the principal balance of loans from our measure of related party transactions, since only the interest charges on the loans would ordinarily be subject to a Section 482 adjustment). These 121 corporations, according to IRS, account for approximately half of the total sales of all foreign-controlled corporations. We assume that the untabulated corporations engage in related-party transactions to the same degree as the tabulated ones, and thus double the figures reported for the 121 corporations.

   With regard to U.S. based multinationals, the IRS has compiled data only for the 744 with more than $500 million in assets. See, John Latzy and Randy Miller, "Controlled Foreign Corporations, 1988," Statistics of Income Bulletin, Fall 1992, p. 71. This article (at p. 66) reports $143 billion in related party sales of "stock in trade" with 7500 foreign subsidiaries. Unpublished data compiled for the Multistate Tax Commission by the Statistics of Income Division counts an additional $33 billion in related party sales of services, royalties, interest, etc. Since the IRS reports that the 7500 foreign subsidiaries of these 744 U.S. parents account for fully 92 percent of the sales of all U.S. controlled foreign subsidiaries, we have not extrapolated the related party transactions upward.

6. There were 44,840 U.S. corporations controlled by foreign persons that filed 1989 tax returns. See: James R. Hobbs, "Domestic Corporations Controlled by Foreign Persons, 1989," Statistics of Income Bulletin, Winter 1992-93., p. 7. The IRS also reports that 750 U.S. corporations with assets over $500 million control 7500 foreign subsidiaries. See: John Latzy and Randy Miller, "Controlled Foreign Corporations, 1988", Statistics of Income Bulletin, Fall 1992, p. 71. However, this is by no means a complete count of U.S. based multinationals. A much more comprehensive compilation by the U.S. Commerce Department indicates that there are actually more than 2000 U.S. based multinational corporations that own a majority interest in over 15,000 foreign subsidiaries. U.S. Dept. of Commerce, U.S. Direct Investment Abroad, 1989 Benchmark Survey, Final Results, October 1992, p. M-25. It is worthy of note that a listing by Treasury and IRS of Commerce Department data sources that could be of use in Section 482 enforcement completely omitted this extremely comprehensive survey of foreign direct investment and a comparable one covering investment in the U.S. by foreign multinational corporations. See, U.S. Department of Treasury and Internal Revenue Service, Report on the Application and Administration of Section 482, April 9, 1992, p. 5-15.

7. See endnote 5.

8. Statement of Louis M. Kauder before the Governmental Affairs Committee of the United States Senate, March 25, 1993, photocopy, p. 9.

9. See: Kathleen Matthews, "Dolan, Pearlman Square Off Over Arm's-Length v. Formula Approach," Tax Notes, March 25, 1991, p. 1335; Lawrence H. Summers, "Taxation in a Small World," in Herbert Stein, ed., Tax Policy in the Twenty-First Century, (New York: John Wiley & Sons) 1988, p. 71; Stanley I. Langbein, "A Modified Fractional Apportionment Proposal for

Tax Transfer Pricing," Tax Notes, February 10, 1992, pp. 719-730; Michael J. McIntyre, "Design of a National Formulary Apportionment Tax System," in Proceedings of the Eighty-Fourth Annual Conference of the National Tax Association-Tax Institute of America, 1991, pp. 118-124; Louis M. Kauder, "Intercompany Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment Now," Tax Notes, January 25, 1993, pp. 485-493; and Dale W. Wickham and Charles J. Kerester, "New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?" Tax Notes, July 20, 1992, pp. 339-361.

10. See: U.S. Department of Treasury and Internal Revenue Service, Report on the Application and Administration of Section 482, April 9, 1992, pp. 3-3, 3-4.

11. Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States, Hearing before the Subcommittee on Oversight, of the Committee on Ways and Means, House of Representatives, April 9, 1992, pp. 145-6.

12. This statement could be affected, however, by the outcome of a pending case, *Barclays Bank PLC v. Franchise Tax Board*, 2 Cal.4th 708 (1992). California has prevailed through the California Supreme Court in this case, which involves a challenge to the constitutionality of the application of worldwide unitary combined reporting to a foreign parent corporation. Barclays Bank is seeking U.S. Supreme Court review of the case. In 1983, in the landmark case of *Container Corp. v. California Franchise Tax Board*, the U.S. Supreme Court upheld the constitutionality of worldwide unitary combined reporting as applied to U.S. based multinationals.

13. Article 9-1 of the U.S. Model Tax Treaty provides:

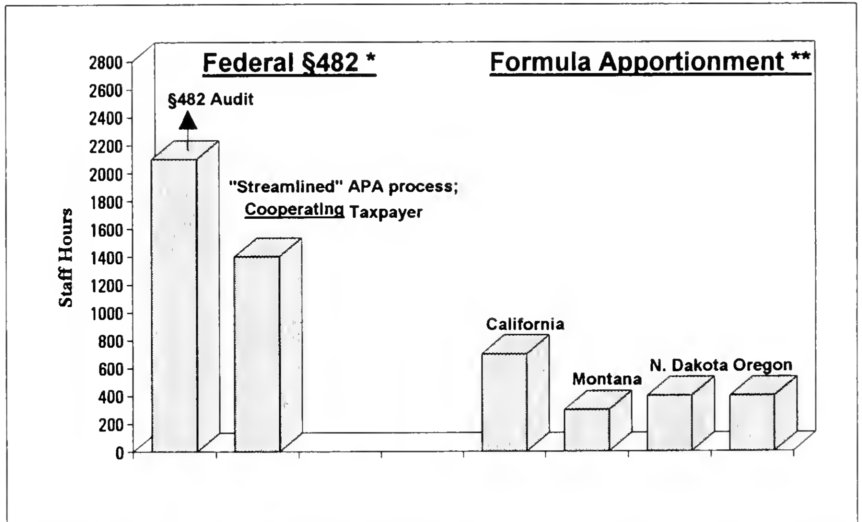
1. Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

(b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any **profits** which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the **profits** of that enterprise and taxed accordingly. **[Emphasis added]**

Administrative Staffing Requirements:

Federal §482 vs. Global Formula Apportionment



* Audit or advanced approval of limited set of related-party transactions. Source: U.S. Treasury Dept. and Internal Revenue Service, "Report on the Application and Administration of Section 482", April 1992, pp. 3-3, 3-4.

** First audit, covering three tax years, total tax liability. Subsequent audits generally require considerably fewer audit hours because facts to support determination of combined group have already been established. Source: Multistate Tax Commission Survey of State corporate audit directors.

Mr. BREWSTER [presiding]. Thank you, Mr. Bucks.
Next is Mr. Smoot.

STATEMENT OF OLIVER SMOOT, EXECUTIVE VICE PRESIDENT, COMPUTER & BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION

Mr. SMOOT. Thank you, Mr. Chairman and members of the committee.

We appreciate this opportunity to appear before you today. My name is Oliver Smoot, and I am executive vice president of the Computer & Business Equipment Manufacturers Association, known as CBEMA.

Our members are leading U.S. providers of information technology products and services in the area of computers, business equipment and telecommunications. Our members alone are responsible for 21 percent of all U.S. industrially funded research and development.

CBEMA supports the objectives of President Clinton's economic plan, especially the overall goal of reducing the deficit. However, we are concerned about two of the tax provisions in the international area, the treatment of royalties and the cutback on deferral.

The Treasury explanation indicates that the two provisions were included to address the concern of the movement of U.S. business facilities offshore. The provisions, however, fail to target only those who move plants directly abroad. Instead, they impose a penalty on all U.S. based companies that do business overseas, and actually fail to achieve their ultimate goal of discouraging runaway plants. The provisions have the perverse effect of actually providing a greater tax incentive for foreign expansion.

The royalty proposal requires that the income with respect to any royalty, regardless of where the underlying development expenses are deducted, is to be characterized as passive for purposes of the foreign tax credit calculation. This change departs dramatically from the treatment of foreign earned royalties afforded many foreign based firms by their base countries.

We object to the characterization of royalty income as passive, for several reasons. Any way you look at the operations generating these royalties, they result in the conclusion that this income is clearly not passive in nature. The administration argues in support of this proposal that the passive characterization is justified, because royalty income is subject to relatively low tax rates, and because the current rule encourages runaway manufacturing plants. Neither argument can withstand greater scrutiny.

While royalties may be subject to relatively low rates in foreign jurisdictions, this income is certainly not the only type of low-taxed income. Therefore, by singling out only royalty income, this provision disproportionately impacts certain industries such as our high-technology industry, without affecting others.

The high-technology industry is not leading an exodus of jobs outside the United States. We are struggling to remain internationally competitive. To the extent we must compete against our foreign based competitors who are not subject to similar rules, it will

be more difficult for the industry to maintain the number of highly skilled high-wage jobs that we have in the United States.

Regarding the runaway plant concern, tax considerations are generally secondary in considering plant location decisions. Tax law considerations are overshadowed, as you have heard, by factors such as requirements to establish local manufacturing presence, the need to minimize distribution and Customs costs, and in our industry, in particular, the need to be closer to the customer.

But even if one continues to believe that tax considerations do drive plants overseas, then this proposal, as you have heard, takes a step in the wrong direction, because it actually would encourage more research facilities to be relocated offshore. Rather than encouraging U.S. firms to build new manufacturing operations in the United States, the more likely consequence will be for firms to move their R&D operations offshore, to be combined with their foreign manufacturing facilities.

The R&D jobs that are in the United States are some of the most highly skilled and paid jobs we have that are available to a large number of persons. They provide good wages to the individuals, and they are essential to the next generation of products that we need to develop. By encouraging firms to move these operations offshore, we will not only lose some of the best jobs we have today, but we will also lose the high skills that will be necessary for tomorrow's better jobs.

In short, we strongly urge that this proposal be dropped from any final package. It should simply be abandoned at this point, and the 64 percent solution to the R&D allocation should be adopted by regulation, once and for all.

As for the proposed cutback on deferral, we oppose this proposal on both tax policy and competitiveness policy grounds. As presently structured, the provision is merely an arbitrary partial expansion of the PFIC rules on a retroactive basis. Moreover, without any analysis as to the amount of working capital cash necessary to run an operation, and without any concern for the time in which a 25 percent return on assets can be earned, the proposal disproportionately impacts high-technology industry in which a 25 percent return on assets is not an uncommon return in any given year. As such, the proposal will force those in our industry to reinvest earnings abroad on a very tight timetable, without regard to business needs, thus forcing us to make investments that we might otherwise not make in order to avoid an immediate tax.

In sum, Mr. Chairman, CBEMA strongly urges this committee to drop the two international provisions I have discussed today which deal a major blow to our industry. We would welcome the opportunity to work with you and the committee and the administration to find alternative means to accomplish these goals.

Thank you.

[The prepared statement follows:]

TESTIMONY OF OLIVER SMOOT
Computer & Business Equipment Manufacturers Association

Mr. Chairman and Members of the Committee. My name is Oliver Smoot and I am Executive Vice President of the Computer and Business Equipment Manufacturers Association (CBEMA).

CBEMA's members, specified on the attached list, are the leading U.S. providers of information technology products and services in the area of computers, business equipment and telecommunications. They had combined sales of more than $225 billion in 1991, nearly 5% of our nation's gross national product. CBEMA members employ over 1 million people in the United States and are responsible for 21% of all U.S. industrially funded research and development.

Because CBEMA member companies are truly global -- 50% of their revenues are derived abroad -- their economic health depends crucially on a broad-gauged U.S. policy aimed at facilitating their efforts to compete worldwide. Our members are focused on policies aimed at opening foreign markets to U.S. firms and exports and assurance that they have access to the most advanced components and resources worldwide.

CBEMA supports the objectives of President Clinton's economic plan, especially the overall goal of reducing the federal deficit. Our members are willing to pay their fair share.

However, CBEMA is concerned about two of the tax provisions in the international area: the treatment of royalties as passive basket income for foreign tax credit purposes and the cutback on deferral. The Treasury explanation indicates that the two provisions were included to address the concern of the movement of U.S. business facilities offshore. The provisions, however, fail to target only those who move plants directly abroad. Instead, they impose a penalty on all U.S.-based companies that do business overseas and actually fail to achieve their ultimate goal of discouraging runaway plants. The provisions have the perverse effect of actually providing a greater tax incentive for foreign expansion.

I. IMPACT OF PASSIVE CHARACTERIZATION OF ROYALTIES ON COMPETITIVENESS

Under this proposal, the current 64 percent direct allocation of U.S. performed R&D expenses to U.S. source income will be increased to 100 percent. This change generally follows the rules provided by other countries who also are eager to hold and increase the number of highly skilled, high wage jobs in their respective countries.

The proposal also requires that the income with respect to any royalty, regardless of where the underlying development expenses are deducted, is to be characterized as passive for purposes of the foreign tax credit calculation. As such, this treatment of royalties would depart dramatically from the treatment of royalties, rents, interest and other similar types of income that was considered one of the cornerstones of the international provisions of the 1986 Tax Reform Act.

This change also departs dramatically from the treatment of foreign-earned royalties afforded many foreign based firms by their base countries. By treating royalties as passive income, the provision eliminates the ability to average high and low tax income earned abroad so as to bring the foreign tax rate down to the U.S. level. As such, for companies in an excess credit position, this change is analogous to increasing the tax rate on royalty income by the new corporate tax rate of 36 percent. Many foreign countries, like France, in contrast, reduce the tax imposed on foreign royalty income.

We object to the characterization of royalty income as passive for several reasons. This income is clearly not passive in nature. For companies involved in research and development, royalties are the active return generated from those activities. Similarly, for many software companies royalties may be the only income generated. Certainly, such businesses are clearly distinguishable from truly passive-type business operations. Moreover, in other areas of the Income Tax Code, where royalties are segregated according to whether they are "active" or "passive", these types of royalties are always characterized as active. As such, there is no rational basis for treating such income as passive.

The Administration argues in support of this proposal that the passive characterization is justified because royalty income is subject to relatively low tax rates and because the current rule encourages runaway manufacturing plants. Both of these arguments, however, cannot withstand greater scrutiny.

A. The Provision Targets High Technology Companies.

While royalties may be subject to relatively low rates in foreign jurisdictions (although they are not always low taxed), this income is certainly not the only type of low taxed income. Indeed, by singling out only royalty income, this provision disproportionately impacts certain industries, such as the high technology industry, without affecting others.

The effect of this selective targeting is that the provision increases the tax rate for only those companies that earn this one form of income. Taxpayers who rent tangible property, as opposed to licensed intangible property, remain unaffected. Similarly, taxpayers who earn their return from foreign subsidiaries in the form of interest income or dividends remain unaffected. As such, not only does the proposal fail to address the problem of all low tax foreign source income, but its selective approach specifically targets high technology companies that conduct R&D in the United States and license it offshore.

The high technology industry is not leading an exodus of jobs outside the United States. We are struggling to remain competitive. To the extent we must compete against our foreign-based competitors who are not subject to these rules, we are handicapped. This handicap will make it more difficult for the industry to maintain the number of highly skilled, high wage jobs we have in the United States.

B. The Provision Promotes Runaway R&D Facilities.

Regarding the runaway manufacturing plant concern, we believe tax considerations are generally secondary in considering plant location decisions. Tax law consideration are overshadowed by factors such as a requirement to establish a local manufacturing presence, the need to minimize distribution and customs cost, and the need to be closer to the customer. As such, we do not believe the current regime

encourages companies to move manufacturing plants abroad. But even if one continues to believe that tax considerations will drive plants overseas, then this proposal takes a step in the wrong direction because it actually would encourage more research facilities to be relocated offshore.

Specifically, this proposal would encourage firms to change the form of their income earned with respect to overseas operations from royalty income to other types of income. For example, to the extent a company conducts both R&D and manufacturing, no royalty payment is required since the technology is not licensed to the ultimate customer. Thus, this provision will encourage firms to combine their manufacturing and R&D functions within the same entity.

Rather than encouraging U.S. firms to bring their manufacturing operations back to the United States, the more likely consequence will be for firms to move their R&D operations off-shore to be combined with their manufacturing facilities. Providing such a perverse incentive may be penny-wise, but is certainly pound foolish. The R&D jobs that remain in the United States are some of the most highly skilled and highly paid jobs available to large numbers of persons. These jobs not only provide good wages to the individuals so employed, they provide essential on-the-job training for the next generation of R&D endeavors. By encouraging firms to move these operations offshore, we will not only lose some of the best jobs the United States has today, but we will also lose the high skills that will be necessary for tomorrow's employment opportunity.

C. The Provision is Not Consistent Tax Policy.

We understand that the Treasury Department has informally stated that an additional reason for this provision is to match more closely the source of income and expenses. If the purpose of the provision from a tax policy perspective is to so match income and expenses, however, the provision is far too overreaching. For example, none of the expenses associated with foreign subsidiary conducted R&D may be deducted in the United States. Therefore, there is no matching problem associated with royalties paid with respect to this R&D being excluded from the passive characterization. Similarly, most of the expenses associated with building the value of a trade name or trademark in a foreign jurisdiction is allocated to foreign source income. Therefore,

there is no matching problem with respect to foreign trademark and trade name royalties. Yet the Administration's provision incorrectly includes these royalties as well.

Moreover, the difficulty associated in matching U.S. conducted R&D with foreign income is exactly the same issue Congress has been struggling with under the section 861 rules. The Treasury Department, as announced in Revenue Procedure 92-56, is supposed to be studying that very same issue this year. If this matching of expenses with income is really the concern, it should be dealt with under the section 861 rules as was announced. It should not be dealt with, as it is here, by inappropriately avoiding the expense allocation issue altogether and adopting a completely new regime for characterizing income.

In short, CBEMA strongly urges that this proposal be dropped from any final package. It hurts America's industry of tomorrow, without any job saving benefit today. It should simply be abandoned at this point and the 64 percent solution should be adopted by regulation once and for all.

II. THE PROPOSAL TO CUTBACK DEFERRAL

Under the administration's excess accumulation proposal, U.S. shareholders of controlled foreign corporations (CFCs) with passive assets in excess of 25 percent of total assets will be forced to pay a tax on that excess to the extent such amount is equal to or lesser than the CFC's total accumulated and current earnings and profits. The purpose of this provision is to bring manufacturing jobs back to the United States.

CBEMA opposes this proposal on both tax policy and competitiveness policy grounds.

A. The Provision Is Technically Flawed.

As it is currently structured, the provision is merely an arbitrary partial expansion of, the PFIC rules on a retroactive basis. Under the current PFIC rules, a foreign company is a PFIC if 75 percent or more of its income is passive or if 50 percent or

more of its assets are passive. The Administration's proposal, in effect, lowers the passive investment threshold to just 25 percent of assets. It does this, however, without any analysis as to the amount of working capital cash necessary to run an operation and without any concern for the time in which a 25 percent return on assets can be earned. In the high technology industry, a 25 percent return on assets is an not uncommon return in one year, even taking into consideration any possible IRS adjustment. As such, the proposal will force those in our industry to reinvest earnings abroad on a very tight time table without regard to business needs thus forcing us to make investments that we otherwise might not make to avoid an immediate tax.

Moreover, passive investments by CFCs are generally made with earnings from prior years. By taxing passive investments under an income tax regime, preenactment earnings are clearly being targeted. As such, to the extent the proposal raises money, it does so only from those firms who are the least able to shift investments into active pursuits. Such firms are likely to be the more medium sized companies and the high technology companies that traditionally are less diversified than other more traditional industries tend to be.

B. The Provision Will Not Achieve the Desired Result.

As we stated before, companies do not make the decision to operate offshore for tax reasons. Rather, they do so for business reasons associated with gaining market acceptance or to reduce transportation or duty costs. As such, changing the tax consequences of those decisions will not bring foreign facilities back to the United States.

Instead, this provision actually encourages firms to expand overseas. Specifically, companies who are nearing the 25 percent threshold should consider investing their passive assets in active foreign business ventures. While such investments will not be made where there is a business reason to expand domestically, to the extent a company is indifferent as to where the next expansion should be, this provision imposes a significant penalty on bringing the funds back to the U.S. for domestic expansion.

C. The Current Deferral Rules Support High Wage U.S. Jobs.

Most U.S. based firms in the high technology industry maintain their supervisory, administrative and engineering jobs in the United States. For example, although over 50% of CBEMA members' revenues come from exports, less than 15% of our R&D is conducted outside of the United States.

These proposed provisions make it increasingly difficult for our companies to compete against our foreign-based competitors who do not have to contend with these rules. Indeed, many of our strongest competitors receive complete active business tax deferral or tax sparing, under which income associated with foreign business activities are never taxed. This cut-back in deferral will make us less competitive and make it more difficult for our companies to keep the current number of Americans employed.

In sum, CBEMA strongly urges this Committee to drop the two international provisions I have discussed today which deal a major blow to the high technology industry.

We would be happy to answer any questions you may have.

Mr. BREWSTER. Thank you, Mr. Smoot.
Mr. DeHaven.

STATEMENT OF ROBERT DeHAVEN, CHAIRPERSON, NATIONAL COMPETITIVENESS COMMITTEE, AMERICAN ELECTRONICS ASSOCIATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, QUALITY SYSTEMS INC., FAIRFAX, VA.

Mr. DEHAVEN. Mr. Chairman and members of the committee, I am Bob DeHaven, founder and CEO of Quality Systems, Inc. We employ over 300 scientists and engineers in Fairfax, VA, and are a wholly owned subsidiary of Penn Central Corp.

I am also the chairman of the National Competitiveness Committee of the American Electronics Association, and a member of its board of directors. The AEA is the Nation's largest electronics association, with over 2,800 corporate members. Our industry represents more than 2.5 million high-technology workers.

We ask you to keep three major issues in mind, when reviewing the President's economic initiatives: First, the Federal deficit; second, American jobs; and, third, our ability to compete globally. As Peter Druker said, within 5 years we will have two kinds of CEO's, those who think globally and those who are unemployed.

Mr. Chairman, I have been assured that my appearance here on April Fools' Day is purely coincidental, and I trust if that is not the case, you will let me know now.

I believe that my written testimony has been distributed to you and, in the interest of time, rather than reading it aloud, I would like to make a few points and highlight some important items.

AEA was quick to applaud the President's early effort to develop a plan to reduce the deficit. We urged the Congress to enact strong spending cuts and use those savings along with increased tax revenues to reduce the deficit, stimulate the economy, to increase jobs, and encourage business and technology investments that will pay off globally. These initiatives will require sacrifice, and we understand that we all have to pay our fair share.

A significant number of our members are defense contractors and they are well experienced in the process of sacrifice. Downsizing has hurt the individual investors in these companies, as well as the thousands of employees who are now without jobs. Many companies are leaving the industry.

For example, Penn Central, our owner, when they announced that they were getting out of the defense business, their stock rose from $17 a share to $28⅝ in a matter of days. That is what Wall Street thinks of my business.

AEA believes that the administration's tax initiatives can be improved, so that the Government and the taxpayer will get more value in terms of jobs and economic growth. My written testimony offers specific suggestions on capital gains, R&D tax credit, executive compensation, stock options and, of course, international provisions.

I will confine my comments to our macro position on key items and refer you to my written testimony for the details.

Capital gains: The Matsui-Bumpers-Brown Enterprise Capital Formation Act was endorsed by candidate Clinton, was passed by the 102d Congress, was cleared by the Joint Tax Committee, and

was hailed by industry and policy experts. The AEA believes the bill would result in new long-term risk capital, in new high-technology jobs, in new economic growth.

Frankly, we are perplexed by the administration's alternative plan. It confines the original act to the point that would minimize its effectiveness. In short, the AEA endorses the original Matsui-Bumpers-Brown legislation.

R&D tax credit: A recent AEA survey showed that less than half of our members currently benefit from the R&D tax credit, because of the alternative minimum tax, anomalous base years and start-up rules. We understand that Senators Baucus and Danforth introduced legislation last week that will rectify this situation and that members of this committee plan to introduce similar legislation soon. AEA strongly endorses these actions, because they still stimulate R&D and improve our competitive posture.

Executive compensation: AEA believes that the responsibility and the power to control executive compensation rests with the companies' shareholders, not with the Federal Government. We endorse full disclosure along the line set forth last year by SEC Chairman Breeden.

Stock options: Stock options are invaluable to the entrepreneur for raising capital, for attracting highly skilled personnel, and for encouraging excellence as he grows his company. Although outside the administration's set of initiatives, the Financial Accounting Standards Board's efforts to change the accounting rules applicable to stock options are particularly onerous.

They propose charging outstanding options to income, thus reducing earnings and, therefore, an entrepreneur's ability to raise capital and reward his employees. This action is opposed not only by industry, but by the shareholders groups and the institutional investors that it is designed to protect. If FASB does not change its course of action, we plan to seek congressional support in this area.

Mr. Chairman, I appreciate the opportunity to testify on these important matters, even on April Fools' Day. Certainly, on some items we seek substantial change, but we believe that America will be rewarded with these changes in terms of new jobs and economic growth. AEA believes that the committee is headed in the right direction, and we stand ready to help.

Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT DeHAVEN
President and CEO of Quality Systems Inc., Fairfax, Virginia
and
Chairperson, National Competitiveness Committtee of the
American Electronics Association

Mr Chairman -- members of the Committee -- my name is Bob DeHaven I am the Chief Executive Officer of Quality Systems Incorporated (QSI) -- a company based in Fairfax, Virginia --- employing 300 scientists and engineers.

I am also chairman of the National Competitiveness Committee of the American Electronics Association and a member of its Board of Directors. The AEA is the nation's largest electronics association, representing more than 2,800 companies from all segments of the high technology industry All of our companies are interested in the Clinton Administration's economic initiatives because they directly affect issues that our industry cares deeply about, including deficit reduction, job creation, and the ability of companies to compete in a global marketplace

Mr Chairman, one day after the President's State of the Union Address, the AEA issued a press release in which we praised the President's economic initiatives as a bold and meaningful attempt to deal with the budget deficit. We also made it clear that we thought several of the tax proposals -- especially in the international arena -- were in need of revision. We also urged that the cuts in domestic spending be meaningful and dedicated to no other cause than real deficit reduction Nonetheless, the overriding purpose of the release was to give the President credit for dealing honestly and squarely with a problem too long ignored by our nation's leaders and by all Americans

It is in this spirit that I talk with you this morning. The AEA supports the serious efforts underway by the President and Congress to deal with the deficit. We realize that tax increases may be a necessary part of deficit reduction. We believe and accept fully the notion that our industry must play its part in the national sacrifice needed to get our fiscal house in order. I should note that many AEA companies, like my own, are defense oriented and -- with recent cuts in the defense budget -- have already begun a very real and painful process of sacrifice. Plant closings and downsizings have hurt the average individual investors of these companies as well as the hundreds of thousands of employees who now find themselves without a job.

The AEA believes the tax initiatives being proposed by the Administration can be improved so that Americans can get far more value for their investment dollar. Two significant areas are the President's proposals on capital gains and the research and development tax credit. In the international tax proposals, we believe the President's initiatives are misguided and could have significant ramifications for our ability to compete internationally. In this light, we strongly urge that the President's proposals on deferral and foreign royalties be eliminated. We also have significant concerns on the President's proposal to limit the deduction companies can receive for executive compensation.

Capital Gains

Let me first address the issue of capital gains. The AEA was delighted that during the recent Presidential campaign, candidate Clinton specifically endorsed the Matsui-Bumpers-Brown Enterprise Capital Formation Act. This legislation was passed in the 102nd Congress by the House and Senate; cleared by the Joint Tax Committtee as costing under $1 billion; and hailed by industry, policy experts and political leaders of both parties as representing good public policy that addressed a fundamental need in this country. I am referring to the overwhelming --- and in many cases insurmountable -- inability of America's entrepreneurs to attract long-term, risk capital to develop new technologies and create new jobs. Institutional venture capital disbursements in new developing companies have fallen from $4 billion in 1987 to $1.9 billion in 1990 to $1.4 billion in 1991. Even more importantly, individual investors, who commit some $50 billion per year to small growth companies, have also dramatically reduced their venture investments.

Mr. Chairman, the early and mid-1980s were the Age of the Start-Up, a period when investment in high technology flourished and a period which produced such giants as Sun Microsystems, Microsoft, and Conner Peripherals. America has benefited from these companies. It has benefited by their exports; the thousands of new jobs they have created; and, the cutting edge technology they have produced. Internationally, the United States is more competitive because of them. But for more than five years our nation has failed to produce a new generation of such companies and a key reason is the inability of American entrepreneurs to obtain seed and venture funding

We were therefore perplexed when the Administration announced that it was proposing a wholly new proposal on capital gains. As we now understand it, the Administration's proposal would reduce the size of qualified companies from $100 million in paid in capital to $50 million; it would restrict the capital gains benefit on the return of an investment to $1 million or 10 ten times the original investment; and, it would limit the proposal to individual investors. We oppose these modifications With the enormous costs involved in developing new technologies, $50 million in paid-in capital is simply too low a threshold. Secondly, limiting the tax benefits on the return of an investment does not take into consideration what motivates investors in high technology companies. Investors in high technology companies realize that it is a high risk investment. And, in contrast to most investors, they take an active role in the company's success and do so only in the expectation that they might be able to reap significant rewards. In addition, let me emphasize that with increased reliance on strategic partnering, corporations will continue to represent an enormous source of equity capital for entrepreneurial companies. To exclude corporations will greatly reduce the significance of the legislation to our industry In sum, we urge the Committee to adopt the Enterprise Capital Formation Act as introduced by Congressman Matsui.

Research and Development Tax Credit

On the research and development tax credit, the AEA this year sent a questionnaire to its entire membership. We sought information on whether companies were using the credit and if not, why not. Our survey results show that many AEA member companies, particularly our smaller members, are receiving significantly less benefit from the R&D Credit than one might imagine. Many AEA companies encounter the alternative minimum tax; (between 40 and 60 percent of the companies surveyed); have anomalous base years (almost 60 percent of our smaller companies); or do not adequately benefit from the start-up company rules. Last week R&D Credit legislation was introduced by Senators Danforth and Baucus and will soon be introduced by members of this committee. Besides making the credit permanent --- which is the most important reform Congress could enact -- the legislation improves the rules regarding the AMT; broadens the Credit's historical base period, and, provides a 10 percent flat rate credit for smaller companies. AEA believes this legislation improves the Administration's proposal on the R&D Credit for all companies. We believe it will greatly stimulate the development of R&D in this country and improve our international competitive position.

Executive Compensation Limitation

I'd like to turn briefly to the Administration's proposal to limit the deduction companies can receive for compensation over $1 million. We believe that the proper method of controlling excessive compensation lies with the company's shareholders. Last year, then SEC Chairman Breeden announced a series of disclosure reforms, and AEA endorsed them wholeheartedly. Having noted our policy concerns, let me add AEA greatly appreciates the Administration's willingness to provide an exemption for performance based compensation. We hope this exemption will include stock options because -- by their very nature -- options are performance based. Stock options enable the high technology industry to raise capital; attract qualified engineers and personnel; and encourage excellence in employee performance. Any effort that would limit their use is of great concern to us.

FASB Valuation Project

On a similar issue but one outside the Administration's set of initiatives, the AEA has been taking a lead role in opposing the Financial Accounting Standards Board's project to change financial accounting for stock options. AEA has received more concern from its membership on this proposal than virtually any other issue in its history. If high tech companies are forced to take outstanding options as a charge on their income statements (which they have not been required to do in the past), they will -- by virtue of this accounting change -- see their earnings reduced and their ability to raise capital crippled. Moreover, this change could severely damage the entrepreneurial culture of America's high technology industries. One of the foundations of that culture is the large percentage of workers at all levels who now receive stock options. By dramatically reducing their reportable earnings,this accounting change would force many companies to abandon their broad-based employee stock option plans. This proposal is opposed not only by industry and policymakers but also by shareholder groups and institutional investors --- the very people that this proposal is intended to benefit. We are hopeful that FASB will change course on this issue. If it does not, we will be seeking Congressional assistance in urging FASB to change the disastrous and harmful direction they are now headed.

International Provisions

Mr. Chairman; there are several speakers who have and who will address the issues of deferral and the treatment of foreign royalties as passive income so I will be very brief. But make no mistake, AEA has major and far-reaching concerns with these proposals. You have heard -- and we certainly concur -- that these proposals are bad policy; anti-competitive; and do not address the issue of runaway plants. Two quick points: One, by treating high technology businesses as passive income generating for purposes of U.S. International tax law, these proposals have a disproportionate and devastating impact on the electronics industry. Ironically, these proposals are inconsistent with the Administration's desire to support the U.S. high technology industry as a primary engine of growth for the U.S. economy. Second, these proposals do not only affect this country's major multi-national corporations. The reality of the global economy today is that even emerging high technology companies must operate overseas if they hope to stay in business in the United States.

Mr. Chairman, the AEA wants to play a constructive role in your deliberations, and we hope you will see AEA as an important resource in the weeks ahead. Certainly, on a few items, we seek considerable modification from the Administration's proposal. We believe our changes can be justified fully from a jobs and competitiveness perspective. AEA believes that the direction you are now headed is the right one. We are willing and ready to be a part of your efforts.

Mr. BREWSTER. Thank you, Mr. DeHaven.
Mr. Warren.

STATEMENT OF WILLIAM A. WARREN, VICE PRESIDENT, TAX, TRW INC., CLEVELAND, OH, ON BEHALF OF THE ELECTRONIC INDUSTRIES ASSOCIATION

Mr. WARREN. Mr. Chairman and members of the committee, my name is William Warren, and I am vice president of Tax for TRW Inc., and I am here today representing the Electronic Industries Association.

With over 1,000 members, EIA represents the entire spectrum of companies involved in the manufacture of electronic components, parts, systems and equipment for communications, industrial, government and consumer-end uses.

EIA supports the President's goal of reducing the Federal deficit and agrees on the necessity of mutually shared sacrifice through fair and equitable means. While we support provisions such as the R&D tax credit, EIA has deep concerns as to the proposed balance between spending cuts and increased taxes in the President's economic plan, and has serious reservations about a number of specific recommended tax proposals.

EIA has particular concern with the proposal to place foreign source royalty income in a separate passive income category and the proposal to partially eliminate deferral of current taxation of income earned abroad. It is our view that these proposals will significantly impact the ability of EIA members to compete globally.

To the extent that U.S. companies are unable to compete in international markets, exports will decrease and there will be fewer job opportunities for Americans. Since exports increase the high-wage, high-benefit jobs found in the U.S. electronics industry, they should be encouraged, not discouraged. EIA is so concerned that we would be willing to forego the proposed incremental investment tax credit in order to eliminate these other proposals.

Let me first address the royalty proposal. This proposal would adversely affect royalties with respect to patents and manufacturing processes, in addition to royalties on trademark, copyright, software and other intellectual property rights.

The President's package ties the royalty provision to a proposal to amend what are generally called the section 861 R&D allocation rules. EIA strongly supports a permanent solution to the section 861 allocation issue. However, EIA also strongly believes the coupling of the royalty proposal with section 861 relief is not justified. We continue to advocate a permanent solution to the R&D allocation issue consistent with the so-called 64 percent solution which is temporarily in place. However, the royalty proposal is so anticompetitive, it should be completely rejected.

The royalty proposal makes the development of intellectual property in the United States less attractive by increasing its cost. The increased cost brought about by this proposal can and will affect decisions that will be made in the future regarding the manner and location of a company's business activity.

At the margin, over time, the royalty proposal encourages companies to increase foreign manufacturing or foreign-based R&D. We believe that there is no justification for a tax policy that encourages

a dilution of America's technology and employment base and a transfer of R&D efforts and employment abroad.

I will now turn to the proposal to partially eliminate deferral of U.S. taxation on certain foreign earnings of U.S. companies. It is essential that the tax and economic programs enacted by this Congress facilitate the creation of U.S. jobs.

The deferral proposal will not create U.S. jobs. In the electronics industry, the primary reason for a decision to locate manufacturing abroad has been the need for daily access to customers and suppliers. Because these economic factors will not change, even with a partial repeal of deferral, the additional tax cost of operating abroad will simply make American companies less internationally competitive. This will reduce U.S. exports which produce foreign manufacturing and, over time, as the ability to compete diminishes, it will even reduce U.S.-based R&D.

In conclusion, EIA urges this committee and the Congress not to embark on a course which will damage the international competitiveness of U.S. companies. We specifically urge that the royalty and deferral provisions not be enacted, and we urge the Congress to work with the Treasury Department in finding a permanent solution to the section 861 R&D allocation issue.

Thank you. Of course, I would be pleased to answer any questions.

[The prepared statement and attachment follow:]

STATEMENT OF WILLIAM A. WARREN
Vice President, Tax
TRW Inc.

On Behalf Of The
ELECTRONIC INDUSTRIES ASSOCIATION
Concerning the President's Tax Package

Before The
Committee on Ways & Means

Thursday, April 1, 1993

I INTRODUCTION AND SUMMARY.

Good morning Mr. Chairman. My name is William Warren and I am the Vice President of Tax for TRW and I am pleased to present the views of the Electronic Industries Association (EIA) to the Committee this morning.

Committed to the competitiveness of the U.S. electronics industry, EIA has been the national trade association representing American high technology companies for over 68 years. Its 1,000 members manufacture 85% of the U.S. production in components, parts, systems and equipment for communications, industrial, governmental and consumer-end uses.

EIA supports the President's goal of reducing the federal deficit, and agrees on the necessity of mutually shared sacrifice. However, we question and are deeply concerned about the balance between taxes and spending cuts in the President's Economic Proposal, and have serious reservations about a number of the specific tax components in the package.

Two such provisions affecting international taxation are the reasons for EIA's testimony today -- the proposal to place foreign source royalty income in a separate "passive income" category for purposes of the foreign tax credit, and the proposal to eliminate deferral of current taxation of active income earned abroad. EIA believes that even if these provisions do raise some revenue in the short-term, their collateral and long-term effects will weaken U.S. companies by reducing their global competitiveness. These proposals will increase costs, result in an ultimate loss of U.S. jobs and will impair the ability of U.S. firms to pay taxes in the future. These results are the very opposite of President Clinton's goals of harnessing technology to drive economic growth and job creation.

These two provisions are so significant with respect to the ability of our members to compete in the global marketplace, and will have such a disruptive effect on the operations of our members, that EIA would be willing to forego the enactment of the President's investment tax credit proposal to eliminate them.

II TREATMENT OF ROYALTY INCOME.

A. Background. The royalty proposal will treat all foreign source royalty income as income in a separate foreign tax credit limitation category for passive income, even if the income reflects the earnings from a taxpayer's active trade or business. (Currently, U.S. companies can aggregate active royalty payments from overseas subsidiaries with active income earned from foreign businesses, i.e., service income, dividends.) The proposal will affect not only royalties with respect to patents and manufacturing processes, but will also adversely affect trademarks, copyrights, software and other intellectual property rights crucial to the success of modern enterprises.

The royalty proposal -- which constitutes a major change from current global marketing practices -- is "coupled" in the President's Revenue Package with a proposal to amend the Section 861 rule to allow allocation of all R&D expenses to the place of performance of the R&D. No explanation is given for combining these two very different provisions.

The EIA strongly believes that there is no justification for coupling these two proposals. In fact, the two proposals will create opposite results. The allocation proposal makes U.S. R&D spending more attractive; the increased taxation of the royalty income such R&D earns abroad makes it less attractive. The royalty provision and the rules for allocating R&D should individually stand on their own merits. And on the merits, the royalty proposal is so anti-competitive that we do not believe it should be considered.

On a separate but related note, EIA has long advocated and continues to support an approach that will allocate 64% of R&E expenses to the place of performance and allow the remainder to be allocated based on either sales or gross income. See Code § 864(f) and Rev. Proc. 92-56, I.R.B. 1992-28. EIA believes that while a 100% allocation can be justified, EIA will not support the proposal to allocate all expenses to place of performance if the "price" of such a rule is allocation of all foreign source royalty income to the passive income basket.

B. The royalty proposal will substantially increase costs and thus seriously erode our members' competitiveness in the global marketplace. The economic future of many of our members, and the jobs for many of their U.S. employees, depend heavily on the ability of our member companies to compete in the global marketplace. As the Clinton Administration has recognized, the ability of our companies to compete, and for American workers to compete, "depends less on traditional factors such as natural resources and cheap labor. Instead, the new growth industries are knowledge based." Technology for America's Growth: A New Direction to Build Economic Strength, at 7.

Given the standard of living that we all believe should be the right of the American worker, we cannot look to compete on a per-hour wage cost with companies operating in countries with low wage and benefit levels. As a result, the future of our industries and our workers depends upon our ability to compete with the new patents, trademarks, software, and other intellectual property that are the basis of high wage jobs. EIA's historic strength has been its members' ability to develop new ideas and to use innovative processes to create and manufacture technologically superior products and services to meet the needs of the global marketplace.

The royalty proposal will hamstring those efforts by penalizing the worldwide commercialization of our members' technological creations. Our nation's leadership in the electronics industries is constantly challenged from aggressive and well-financed international competitors. We can retain superiority in this field only through a consistent effort and only if the competitive playing field is level. Domestic tax, trade or other government policies that discourage the development or increase the cost of developing intellectual property (upon which breakthrough technology products and services depend) will erode our ability to compete in the global market and to maintain American jobs.

As such, the royalty proposal's increased "tax" upon our companies will create a real barrier to our ability to compete with foreign companies that are not similarly disadvantaged. Moreover, if we lose in the overseas marketplace, we will surely lose in the U.S. market as well.

C. The royalty proposal will disrupt operations of U.S. companies in the global marketplace. The current United States tax system recognizes that intellectual property is integrally tied to the active conduct of a trade or business. Indeed, recent U.S. tax policy has consistently focused on ensuring that royalties reflect the true value of the intangible assets to which they relate. The tax code, under section 367(d) and section 482, has been strengthened to encourage U.S. companies to accurately price the royalties that they charge to affiliates.

This proposal will change this method of operation. Fairly-priced royalties will be faced with a penalty. Current agreements with affiliates, with unrelated parties, and with foreign governments, all based on a fair royalty price, will be disrupted and will need to be reevaluated. At a time when American businesses should concentrate on making better products and improving customer service, additional attention to the costs and benefits of royalty agreements will be necessary.

D. The royalty proposal will dilute America's technology base. This proposal makes the development of intellectual property in the United States less attractive by increasing its cost. As

a result, the increased costs of this proposal can and will affect decisions that will be made in the future regarding the manner and locale of a company's business.

Companies have a variety of possible responses if this proposal is enacted. As noted above, at the margin, a company might be tempted to increase foreign manufacturing or foreign R&D. [NOTE: Appendix A provides an example illustrating the incentive for foreign manufacturing that the proposal could create.]

As an alternative to increasing foreign manufacturing, a company might also have an incentive to give up American ownership of certain intellectual property to a foreign competitor or a joint venturer. A company might even be forced to withdraw from certain foreign markets and cede them to competitors.

We believe that there is no justification for a tax policy that will likely result in both a dilution of America's technology base and a transfer of R&D efforts and employment abroad. It does not make sense for U.S. tax policy to disrupt the current system for a proposal that has only marginal utility and will, in essence, hurt the competitiveness of U.S. industries and provide further disincentives for U.S.-based research.

Indeed, if any revenues are raised from this proposal, it is because the provision will create excess foreign tax credits. Although tax policy alone may not be a sufficient incentive to manufacture abroad, a company with such excess credits will have a marginal incentive to manufacture in a low tax jurisdiction abroad rather than in the United States. That further erodes the ability of the electronic industries to create good U.S. jobs for U.S. citizens.

E. <u>The royalty proposal could result in a loss of U.S. jobs</u>. The decisions as to where to own and develop intangibles generally are driven by concerns other than tax motivations. These decisions are based primarily on the need for proximity to customers and suppliers, the existence and availability of a highly skilled workforce, and the overseas market involved. As the Wall Street Journal recently reported, "company officials say that they located abroad not to dodge U.S. taxes, but to take advantage of the same low labor rates and raw material prices that their European and Asian rivals have access to." <u>Clinton Plan for Foreign Operations Draws Complaints from U.S. Companies</u>. Wall Street Journal, Thursday, March 25, 1993, at A-3.

However, the increased costs of doing business that are bound to result from the royalty proposal will only hurt U.S. companies' competitive position in the global market. To the extent that U.S. companies will be unable to compete, contracts will be lost, business will decrease, and there will be fewer job opportunities for Americans. Since exports increase the high wage/high benefit jobs that are found in the U.S. electronics industry, they should be encouraged, not discouraged.

F. <u>The royalty proposal will not raise significant revenue in the long run</u>. The proposal will have some short-term revenue raising effect, but as discussed above, companies in excess credit positions can and will adjust their operations to deal with the proposal -- and such adjustments will have adverse economic effects on U.S. companies and their workers.

G. <u>The royalty proposal is not based on sound tax policy</u>. There are no sound or compelling tax policy reasons for this proposal. It violates the standard principles of equity, efficiency and neutrality in the operation of tax policy. The proposal is inequitable, singling out high technology industries; it is inefficient, causing substantial disruption in planning and compliance; and it is not neutral, treating taxpayers in similar tax situations differently (accordingly to historic accumulation of tax credits).

Generally, the Tax Code has required separate "baskets" for passive income only when the nature of the income was that it was fungible and easily movable. Royalty income is not in that category. The source of such income depends on the country in which the use (or right to use) the intangible arises. This proposal is an indirect method of changing that fundamental rule. In addition, the royalty proposal appears to make an argument that royalty income should be in a separate basket because it is not heavily taxed. This argument is overbroad, and if taken to the extreme, can lead to infinite transactional basketing.

Finally, under the proposal, royalties will be arbitrarily treated differently from other types of income, such as dividends and interest, received from related parties. Moreover, such a rule will distinguish between branches (which can acquire intangibles as tax-free capital contributions) and subsidiaries of related corporations.

H. The royalty proposal is unsound economic policy. It is incorrect as a matter of economic policy to tax royalty income as passive income. Research and development activity by U.S. based companies must be encouraged rather than discouraged. The ability to transfer the fruits of that research easily has helped to create and maintain jobs in the United States and has strengthened the economy of the U.S. and of its corporate citizens.

As noted earlier, the royalty proposal in its current form not only places royalties from technology in the passive category but also covers royalties from trademarks, copyrights, and software. In addition to all the other reasons cited above for abandoning the proposal, the lack of any conceptual reason for imposing a penalty on these other classes of intellectual property must also be considered. Many U.S. companies license their trademarks to foreign licensees to gain entry to, or retain market share in, a foreign market. This is good for U.S. exports and good for the overall economic health of U.S. multinational companies. Imposing another layer of tax on this activity, as the royalty proposal will do, will make it more difficult for U.S. companies to compete and over the long term will reduce market share of U.S.-based multinational corporations.

I. Summary. Any tax proposal must take into account the fact that U.S. companies compete in the global marketplace. Indeed, studies have repeatedly shown that exports contribute significantly to job growth in the United States. For example, the Department of Commerce estimates that for every $1 billion in exports, 19,100 jobs are created. U.S. Jobs Supported by Merchandised Exports, Office of Macroeconomics Analysis, Series 1-92, April 1992. Rather than penalizing international operations, EIA believes policymakers must make the United States the world's best place in which to manufacture and from which to export. A fundamental part of this. A fundamental part of this effort is the avoidance of policies like the royalty proposal which impair the ability of U.S. firms to compete and operate in the global market.

Concern with "runaway plants" or other tax sheltered foreign income should be addressed carefully and directly. Blunt tax policy changes should not be adopted when they will disrupt the sectors of the American economy that produce competitive products and high wage employment. The royalty proposal is an overkill to any perceived problem, in that it affects not only manufacturing royalties, but all kinds of intellectual property, and increases the cost of business activity to such an extent that it hampers the ability of American companies to compete abroad.

III CHANGES TO DEFERRAL

A. Background. The deferral proposal will require 10 percent shareholders of certain "controlled foreign corporations" ("CFCs") to include in income currently their pro rata shares of a specific portion of the CFC's current and accumulated earnings. The proposal will apply to a CFC that held passive assets representing 25% or more of the value of the CFC's total assets.[1] In essence, the deferral proposal eliminates to a large extent the concept of "deferral" in our foreign tax system. The U.S. tax system already puts U.S.-based multinational companies at a competitive disadvantage with their foreign counterparts; the deferral proposal will increase that disadvantage.

Most foreign competitors operate under a system (a "territorial system") which does not tax any foreign income. By contrast, U.S. multinationals are taxed on their worldwide income. The foreign tax credit, far from being the special tax preference that some policymakers seem to view it, is really just an adjustment mechanism that prevents double taxation of U.S. income by the United States and by foreign jurisdictions.

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1 The portion of current and accumulated earnings subject to inclusion is the lesser of the CFC's (1) total current and accumulated earnings and profits, or (2) the amount by which the value of the CFC's passive assets exceeds 25% of the value of its total assets.

The concept of deferral in our international tax system prevents multiple taxation of the same items of income, and also respects the tax sovereignty of nations that use a territorial system. It is an important concept not only for these tax policy reasons, but as a means of ensuring that U.S.-based multinationals remain competitive in the worldwide tax system. For the reasons discussed below, the EIA believes that the complete or partial repeal of deferral -- as a means of preventing a perceived export of jobs, fixing a perceived "unfairness," or as a pure and simple revenue raising measure, is, in its operational effect, counter to the goal of enhancing U.S. competitiveness and growing domestic high wage employment.

B. The deferral proposal will harm U.S. companies. The deferral proposal will increase the costs to U.S. companies doing business abroad -- either by increasing taxes or forcing these companies to alter their operations. Thus, the proposal will have a detrimental effect on the benefits of international economic activity. We view this as shortsighted, since the overseas operations of and sales by American companies preserve U.S. jobs by increasing the overall activities and financial strength of U.S.-based corporations.

Indeed, other nations recognize the importance of the global marketplace and provide incentives to their corporate citizens with worldwide operations. Our members compete with foreign multinationals who have the advantages of tax enterprise zones and additional tax or treaty advantages, such as tax exemption for foreign subsidiary dividends. In short, the United States currently provides one of the least favorable rules for the taxation of offshore income. Clearly, if deferral is eliminated the competitive gap will widen, benefiting our international competitors.

C. The deferral proposal will not create U.S. jobs; it will slow U.S. economic growth. Although taxes are a factor in the determination of where businesses decide to locate, they are clearly not the only nor the predominant factor. We believe that in the electronic industries, the primary reason for a decision to locate manufacturing abroad has been the need for daily access to customers and suppliers.

Because the economic factors discussed above will remain the same even if deferral is wholly or partially eliminated, few, if any, business enterprises will relocate their plants inside the United States solely because of a tax change. Instead, the additional tax cost of operating abroad will make American multinational business less competitive and thus reduce its market share and profitability. And while we reject the claims of American decline in high technology, we caution that both the recent macro-level and individual product-level achievements of the U.S. high technology sector are by no means guaranteed and that the pressures associated with international competition will remain intense for the domestic economy. The imposition of a large new tax increase will most assuredly have an adverse affect upon their progress and will harm the President's plan to boost U.S. high-tech leadership in world markets.

D. The deferral proposal will not produce significant revenue. We must seriously question whether the proposal will generate the kind of revenue predicted by the Administration, particularly in the longer term. The Staff of the Joint Committee on Taxation estimates that the deferral proposal will raise between $600 million and $800 million in tax revenues in the first two years, diminishing to $100 million after three years.

These estimates indicate to us that even at its most "optimistic" the revenue effects of such a change are short lived. Moreover, these estimates do not appear to take into account the likely changes in the actions of both foreign governments and multinational corporations which will occur if deferral is wholly or partially repealed. For example, foreign governments will be expected to increase foreign taxes. Indeed, the reaction of foreign governments to the Tax Reform Act of 1986 -- many of whom lowered taxes to reflect the change in the U.S. tax system -- illustrates that foreign taxes are likely to rise again if the U.S. tax system again changes course.

If foreign taxes increase, U.S. companies will merely be paying more to foreign jurisdictions. Moreover, repeal of deferral means that companies will not have the same incentives to minimize taxes paid to foreign governments, and indeed, could change their tax planning to accelerate the payment of foreign income taxes which are postponed, such as foreign withholding taxes.

E. Sufficient rules exist to prevent abuses. Finally, we believe that the deferral proposal is unnecessary because sufficient rules exist to prevent abusive situations. For example, the foreign personal holding company rules (secs. 551-558 of the Code) prevent the use of offshore corporations as "incorporated pocketbooks," where dividends, interest and similar forms of passive income were realized by U.S.-owned corporations located in countries with low or no income taxes. Subpart F itself prevents tax avoidance by treating all items of foreign-base company income as a constructive dividend to the U.S. shareholders that must be reported currently.

F. Summary. In summary, we believe that the deferral proposal will impair the competitiveness of the U.S. electronics industry abroad without increasing domestic employment or providing a domestic economic stimulus. It will create a tax system that is unfair and competitively disadvantageous, and which invites retaliation by foreign countries and a shift of activities of U.S. companies abroad. This proposal runs counter to the goal of strengthening U.S. exports and domestic employment, and will only weaken our industry's attempt to increase its share of the global electronics market.

IV. CONCLUSION.

The President has stated that "the United States must * * * ensure that its tax, trade, regulatory, and procurement policies encourage private sector investment and innovation. In a global [economy] where capital and technology are increasingly mobile, the United States must make sure that it has the best environment for private sector investment and job creation." Technology for America's Growth, supra, at 12.

The royalty proposal and the proposal on deferral will frustrate these important goals by increasing the costs of U.S. business operations in international markets. They have no tax or economic policy justification, and will likely lead to an export of U.S. manufacturing, R&D activities and jobs. These are not the items we want to export. Rather, we want to continue to export the best products and services that our people and our technology can produce. We therefore strongly urge that these two proposals be rejected.

Thank you, Mr. Chairman, for the opportunity to present our views. I would be pleased to answer any questions.

APPENDIX A - EXAMPLE

Assume a U.S. company has a foreign subsidiary with manufacturing operations in a foreign country which imposes a tax of 50% on the foreign subsidiary's income. Assume further that the foreign subsidiary earns $100 in income per year but pays its U.S. parent $30 per year in royalties under a license for intellectual property from its U.S. parent. Finally, assume the foreign subsidiary dividends 100% of its annual after-tax earnings to the U.S. parent. In this case, the total income to the U.S. parent (before foreign and U.S. tax) would be $100.

Assuming no dividend withholding tax, the foreign subsidiary would pay $35 in foreign taxes ($100 - $30 deduction for royalties paid to its U.S. parent) x 50% tax rate). Under the proposal and at current tax rates, the U.S. parent would pay $10.20 in U.S. tax ($30 royalty income from its foreign subsidiary x 34%). There would be no U.S. tax on the dividend income from the foreign subsidiary because of the foreign tax credits bought up with the dividend income. In fact, the U.S. parent would have $11.20 in excess foreign tax credits [$35 foreign tax credits - ($70 "gross-up" dividend income from its foreign subsidiary x 34% U.S. tax rate)]. Thus, total tax on the $100 of foreign earnings of the U.S. company and its foreign subsidiary would be $45.20, for an effective tax rate of 45.2%.

In this situation, if the U.S. parent is considering investing in a new plant, either in the U.S. or a foreign country, the proposal would provide an incentive to the U.S. parent to seek a low-tax foreign country. For example, if the U.S. parent earns $100 of taxable income from a new plant located in the U.S., its total tax bill will increase by $34 ($100 from its new U.S. plant x 34%). Combined with its income from its foreign subsidiary in the country with the 50% tax rate, the U.S. parent would earn $200 of pre-tax income, and would pay $79.20 in tax, for an effective tax rate of 39.6%.

However, if the U.S. company establishes a new foreign subsidiary in a country which, via statutory rates or tax holidays, imposes a tax rate of only 20% on manufacturing profits, it will pay a lower total tax bill. In this case, the new foreign subsidiary would pay $20 on its income before dividending to the U.S. parent. The U.S. parent would be faced with a residual U.S. tax of $14 on that income. However, $11.20 of this residual U.S. tax would be offset by the excess foreign tax credits the U.S. parent has with respect to the dividends it received from its other foreign subsidiary operating in the country with a 50% tax rate as a consequence of the President's royalty proposal. The net result is that the U.S. company would earn $200 of pre-tax income, and pay worldwide tax of $69.00, for an effective tax rate of 34.5%.

Mr. BREWSTER. Thank you, Mr. Warren.

Some of you have suggested that the royalties and deferral provision may lead to the export of R&D activities. Treasury Secretary Bentsen has testified before this committee that, taken as a whole, the President's program will greatly benefit R&D activities in this country. He specifically mentioned permanent extension of the R&D credit and the ITC. I gathered from your testimony that some of you would certainly disagree with that. Would any of you like to make a short response on that?

Mr. WARREN. I would be happy to offer a few comments. I think the issue here is one of competitiveness. As I said in my statement, we must have policies that encourage U.S.-based R&D. And the increased cost from the royalty proposal will, in fact, affect all our operations as well as our ability to compete. In order to have a strong U.S. economy with U.S. jobs, we do need U.S. based R&D, we need a constant flow of new technology into the United States from that U.S.-based R&D, and we need policies that facilitate the ability of U.S. companies to compete on a global basis.

Mr. BREWSTER. I gather from your testimony, too, Mr. Warren, that the ITC is not something that would probably be of great benefit to your company. Would the money be better spent on some other mechanism or changing some other provision of the tax provision?

Mr. WARREN. As I said in my statement, we are so concerned with the royalty proposal and the proposal to partially eliminate the current deferral provisions, that we would be willing to give up the incremental ITC.

Mr. BREWSTER. Mr. Young, you discussed a little bit the runaway plant proposal and it should be more targeted than the President's proposal, and maybe I caught a hint of the possible approach to a way to target it better. Do you have an idea on that?

Mr. YOUNG. Well, I have an idea that was not too enthusiastically received by the administration. I think it may be too complicated, but the idea would be to look within certain SIC codes when you file your tax return, did your employment go down here and go up there, and if it did, you might have to pay an excise tax per person, unless you were doing out-placement and counseling and other things, instead of dumping that off on the public as an externality to your company. That may indeed be too complicated to work out, but I think it is illustrative of at least a methodology that more surgically gets at solving this runaway tax problem.

I think what you are hearing from these last two panels is that the Tax Code that has evolved over the last many years is so woven into international manufacturers' planning and the way they operate their firms, that to just pick out something like this and think it is only going to hit on runaway plants just does not happen at all. So I just think a different approach is required to deal with that runaway plant problem.

Mr. BREWSTER. Thank you.

Mr. Hoagland.

Mr. HOAGLAND. Mr. Young, the experts tell us that we should use revenue bills to raise revenue, not to accomplish other social purposes, and that any proposed changes should be weighed against the principles of fairness, equity and simplification.

I wonder if you would take both of these provisions you are concerned about, the royalty provision and the deferral provision and just summarize for us in a sentence or two what each one would do, and, second, indicate whether the essential purpose seems to be to raise revenue or something else, and, third, how it measures against those three standards.

Mr. YOUNG. Well, I think the royalty one that has been discussed here is one that you have already heard questions about how durable it is going to be in raising revenue. People will do just as you suggest, they will take actions, the tax law will cause people to take management actions, de-focus them from the real business of creating jobs and new products and entering markets, into figuring out how to restructure their operations in order to minimize their tax bill, and I just do not think that is a very constructive way to spend their time.

The same is true of this deferral provision. To the extent that you now have an even retroactive law particularly for accruals, you will be looking for investments and other ways of putting that in a situation where current taxes will not have to be paid, even if it is not the best investment or even if it is not in line with your logical plans, simply because that is probably better than paying taxes in the short term.

So I do not think either one of these are going to accomplish much in the way of raising revenue, and surely both of them will cause a lot of management overhead, doing things that are not productive for the long run. But most importantly, I think they send out signals that are just opposite of what you would like to see. They encourage offshore investments and moving R&D offshore in a way that I just do not think is consistent with the policy directions of the administration.

Again, I think these are maybe a couple of artifacts that have shown up as unintended consequences of things that are really trying to get the deficit down and trying to support R&D, but, unfortunately, these are a little complex issues and maybe all of the facts were not out. Again, we are just delighted to have this opportunity to try to make clear what the impact can be.

Mr. HOAGLAND. Is it your view, as a general matter, that the tax law should avoid trying to direct corporate activity at all and should be neutral in terms of——

Mr. YOUNG. Well, I think, for the most part, that is true, but I think there is certainly a big exception in the case of research and development. I think it is well accepted economic theory that private firms will invest less than would be useful for the public good, and it is not a tax expenditure in that sense, but, rather, a way of getting the right level of investment that serves the broad public, simply because a private firm cannot get all the returns from their own investment. It spills over into the public. That is good, and so the R&D tax credit and things like that, that accent additional R&D, I put into a little different category.

Mr. HOAGLAND. Do you have any thoughts as to how we might plug the revenue hole that taking these two provisions out would create?

Mr. YOUNG. Well, I think you have heard from others a point of view I share, that this temporary investment tax credit is not seen

by most businessmen I have talked to as being all that influential in their decision-making. It is not a lot of money. It is very complicated to keep track of. The accounting costs and so forth would be very high, and I think at the margin it is probably not enough to influence behavioral changes anything like the behavioral changes that will be induced by these two provisions.

Mr. HOAGLAND. I am afraid that has already been spent two or three times, the $12 billion in saving. I think it was spent by the Senate on our behalf in the amendments they have passed the last couple of days. Do you have any other thoughts as to how we might—the President did make a campaign issue out of trying to equalize taxes levied against foreign operations.

Mr. YOUNG. I think that is the case, and there were quite a few revenue numbers thrown around during the campaign. But as I understand the Joint Economic Committee's current score card, that is only on there for about $200 million, considerably less than any of the prior figures.

I certainly think there have to be a number of areas where that could be strengthened, and I think if you wanted to work with some of the multinational firms, you would find a ready willingness to work with you.

Mr. HOAGLAND. Thank you for coming here today.

Thank you, Mr. Chairman.

Mr. BREWSTER. Mr. Levin.

Mr. LEVIN. Thank you.

I would also like to join my colleagues in thanking you for the testimony. While these are busy times and everybody is not here throughout the hearing, my guess is that all the members will be reading your testimony.

I think you have graphically stated one of the questions, whether we have here a laudable goal, but implementation that does not really meet that goal in terms of runaway plants and related issues, whether the deferral provision and the royalty provision, the way they are presented will be effective. It seems to me that issue has to be the primary one, and not the revenue issue, because if these provisions are not good for American competitiveness, including the issue of plants that unnecessarily leave our shores, somehow we would have to find the revenue.

I think your presence here has helped accelerate the debate, and I think the administration appreciates the spirit, if I might say so, with which you approach the issue. Some of you and I think most of your organizations have been actively involved in trying to get us to focus on the deficit and on competitiveness, and I think that gives you more, not less, credibility to raise questions about specific issues, and I think the administration, I would think, would look at your testimony within that spirit.

So we will be working hard on these issues, and we all appreciate your spending the time.

Mr. BREWSTER. Thank you, Mr. Levin.

Gentlemen, we thank you for some excellent testimony. I can assure you all our staffs will go through it in depth, and we appreciate you being here today.

The next panel is Robert McNeill, F. Scott Farmer, J.D. Foster, and Robert Lawrence.

There was supposed to have been a fifth person on your panel, Mr. Peter Nelsen. He had to leave, and his testimony will be put in the record in its entirety.

[The statement of Mr. Nelsen follows:]

INTERNATIONAL TRADE COUNCIL
Statement of Peter T. Nelsen, President
International Trade Council
Before the
U. S. House of Representatives
Committee on Ways and Means
President Clinton's Proposal
for Public Investment and Deficit Reduction
April 1, 1993

Mr. Chairman and Members of the Committee. We thank you for this opportunity to appear and present testimony before the Committee on Ways and Means on the subject of President Clinton's proposals for public investment and deficit reduction.

Part of our testimony relates to basic economic applied theory and part relates to several original proposals that can help improve the U. S. economy and improve the quality of life for the U. S. population.

We address both issues that are important to the U. S. population and the issues that will affect the competitiveness of U. S. industry in the world market.

The International Trade Council represents U. S. producers of products and services in 49 of the 50 states who both export and import. Since U. S. exports have been a main engine of growth for the last two decades for the U. S. economy, it is vital that our industries are not handicapped by new taxes in addition to the debilitating new regulations that have been imposed upon them in the last 20 years.

The Annual Deficit and the National Debt. The 1990 Tax Act imposed a cap on spending which the President and some in Congress now want to circumvent by calling a tax increase "an investment." This is a sham and an insult to the American people who relied on the promise that the budget ceiling would be adhered to as part of the 1990 tax increase and as a way of gradually eliminating the budget deficit and eventually the national debt.

The U. S. collects 18.5% of GNP as tax and spends 24% of GNP. Any company or individual would go bankrupt with that same ratio. The U. S. is heading in that direction now.

To correct our course, the U. S. needs to impose a flexible freeze on total spending. As new needs arise, then corresponding cuts must be imposed so that the total budget remains as is until our GNP rises. Eventually our expenses will match our revenue at between 19 and 20 percent. We presently have an increase in real annual GNP of 3.5%. At this rate with both entitlements and discretionary spending being cut, we would be at breakeven by 1997 or 1998. If we then display the courage to keep expenses one percentum below tax revenue, we can get rid of our debt.

Fiscal Policy. The U. S. economy is presently weak, while the statistics indicate that we are steadily pulling out of the last recession. As long as our unemployment is at 7% our economic growth is politically unacceptable and in dire need of improvement. It is, therefore, not the time to consider reducing debt by increasing income taxes.

It is said that "inflations is the result of fiscal malpractice." It is vital to the economy that whatever is done that inflation is kept down and that the government spending must case crowding out private investment.

One of the stimuli to the economy is the recent reduction in business loan rates and interest on mortgages. This is a positive factor and will help both consumers and producers.

Monetary Policy. Monetary Policy needs to be revised, particularly in the banking sector. The treasury is competing for investment capital on Wall Street with private industry. Banks are borrowing at the Fed discount rate of 3% and lending the money back to the Treasury at 7%, more or less, instead of lending to the private sector for productivity improvements.

The money supply is insufficient and the Fed should be urged to increase the money supply to increase M2 with new money by funding government agency needs directly so that banks will go back to serving their business community.

Whenever the money supply can be increased without inflationary pressure by buying government bonds on the market, we can then reduce the national debt, while keeping a close eye on M2 so that the economy does not overheat and cause inflation.

General Tax Increase. A general tax increase as proposed by President Clinton reduces the peoples' discretionary income, thereby limiting the demand for goods and services and private investment. This results in less production and less employment.

The government, i.e., the White House and Congress, has a compulsive urge to redistribute wealth, by taxing everyone and everything in sight and then trying to help the needy. Most of the needy would not be needy if demand increased in a healthy economy.

If the economy is allowed to grow at its own current momentum, it will generate far more employment than the proposed $16 billion proposed for job generation. Trying to force the economy with government spending is like trying to push on a string. The economy will pull itself out if exogenous political pressure does not interfere.

Economic Stimulus. Accelerated economic growth to increase productivity and making U. S. producers more competitive in the world market can be accomplished by:

1. Investment credit for new plant and state-of-the-art equipment;
2. Capital gains tax benefits for long term investment, i.e., two - seven years depending on useful life of equipment with full credit only over seven years and gradually less benefit down to the two year increase;
3. Accelerated depreciation schedules as further inventive for investment.

It is well known that all corporate taxes are eventually paid by the consumer if the business is healthy enough to pass it on; therefore, the aforementioned three proposals will reduce corporate tax burdens enabling the producer to be more competitive in the world market and thereby being able to hire more workers.

Raising corporate taxes will certainly inhibit demand for labor. In fact, raising taxes has never increased employment in the private sector. Increased productivity yields higher GNP, higher tax revenue and maybe eventually a balanced budget.

Public Investment in People. Public investment can best be done by assisting the private sector economy. As Robert Samuelson recently wrote: "A quick explosion of unproductive jobs won't make a more productive economy." Public investment should be in the form of a better eduction system.

1. Extending the school year for Kindergarten to Grade Twelve from 180 days to 220 days per year. The school day should be extended from five to six (or seven) subjects per day similar to European schools or even to 240 days per year as the Japanese school system is.
2. Technical educational programs in response to particular industry needs paid for by tax credits to the companies who need specifically skilled workers.
3. College subsidies to needy students based on performance and possibly full or partial reimbursement for completion of courses with a B or better grades.

Energy Tax. The proposals from the White House are not well defined, but it appears that the burden will be heavier on segments of the population who can least afford it. Low income families generally have to drive further to work and to obtain community services.

The energy tax will hobble industry arbitrarily in that industries which are energy intensive will be hit harder than others and loose their competitive edge both domestically with product substitution and internationally since increased cost diminishes competitiveness in world markets.

The energy costs imposed upon industry have to be passed on to the consumer thus reducing the purchasing power of the population further. The tax would increase unemployment and in the long run diminish tax revenue to the government. If the government is determined to impose an energy tax, consideration should be given to exempting the use of natural gas. We import about $50 billion of oil and an incentive to make people and industry switch to natural gas from oil will reduce our trade deficit and also reduce exhaust pollution.

We thank you for your consideration of our suggestions. We will be glad to provide further information if the Committee desires.

Mr. BREWSTER. First to testify will be Mr. McNeill.

STATEMENT OF DUANE L. BURNHAM, CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ABBOTT LABORATORIES, AS PRESENTED BY ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. MCNEILL. Thank you very much, Mr. Chairman.

I am here on behalf of my chairman, Duane Burnham, the chairman of Abbott Laboratories, who at the last minute had to make a trip to Japan. I assume that his statement would be the one that would be printed in the formal record.

Most of my colleagues on earlier panels and colleagues on this panel have made and will make the points that I would also make in respect of the several foreign tax proposals submitted to the Congress by President Clinton.

Of the various tax proposals, the organization that I represent, the Emergency Committee for American Trade (ECAT), finds the three most objectionable ones and potentially the most harmful ones to be those defining royalty income as passive income "deferred," and section 936.

You were just talking with the former panel about runaway plants. I appeared before this committee many, many years ago on the Section 86 R&D issue and made the point that if section 861, were changed in the manner that was being proposed at that time, that at least one of the member companies that I represent would indeed likely have a runaway plant. At that time this company had laboratories and other R&D facilities that were old and had to be replaced. The Government of Canada among others was offering incentives to American and other firms to establish research and development facilities in Canada. Indeed this company, in part because of the uncertainty of United States tax treatment of research and development expenditures, did in fact relocate R&D facilities to Canada.

We also are concerned that the enactment of the President's proposals with respect to royalties could very well cause a number of companies similarly to review their research and development activities, with a view as to the locus of such activities.

We also care very deeply about the proposal to partially eliminate foreign tax deferral. We find the proposal terribly objectionable and anti-competitive, as we also do the proposals on section 936 dealing with the tax consequences of doing business in U.S. possessions. We have very serious problems with those particular provisions.

I would like to take a minute or two, if I could, to comment on a study that my organization is about to publish having to do with the relationship of U.S. foreign direct investments to the U.S. economy.

In 1973, when the Hartke-Burke bill was being considered by the Congress, my organization conducted a study to see what the impact of U.S. foreign direct investment was on the U.S. economy. We came out with a survey and a study showing very positive effects.

We were subsequently concerned that in the period of the 1980's, when the U.S. trade balance went from essential neutrality into very substantial deficit, that the picture might have changed. We have just completed our new study on the impact of U.S. foreign direct investments on the U.S. economy and I would like to share with you one or two of its major findings, because I think they deal directly with the matter before your committee.

If you are going to change the taxation of foreign income as proposed by the President, you will be harming the international business operations of U.S. firms. Very briefly, our study shows that during the period of the 1980's, U.S. multinational corporations contributed net surpluses to the U.S. balance of payments averaging a plus of $83 billion annually to the United States. That $83 billion annual average includes both net of foreign trade surpluses and remitted profits from U.S. direct investments abroad. Without these enormous net balance of payments contributions of U.S. multinational corporations, the U.S. trade deficits could very well have been calamitous during the 1980's.

Our new study also shows that the balance of payments surpluses of U.S. international companies rose steadily from an average of $74 billion in 1982 to $130 billion in 1990.

We have other similar findings that I will not repeat here because they are in Mr. Burnham's formal written statement. But anything such as the President's foreign tax proposals that impacts the ability of U.S. firms to compete effectively, not only in the United States, but in the global market, is very harmful.

The 60 companies that I represent, Mr. Chairman, have annual worldwide sales of over $1 trillion. Of that $1 trillion, approximately $300 billion is revenue from the international business operations of these 60 companies. Imagine what the Fortune 500 might look like if these firms did not have their international business. The companies would be indeed much smaller and rather than employing 5 million persons, the number of employees would be substantially less.

We care very deeply about the ability of our respective members to compete internationally, and we find very troubling and anticompetitive the three particular proposals I mentioned.

I have gone past the my allotted time, and I apologize for that. Thank you.

[The statement of Mr. Burnham submitted by Mr. McNeill follows:]

STATEMENT OF DUANE L. BURNHAM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ABBOTT LABORATORIES AND CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE, BEFORE THE COMMITTEE ON WAYS AND MEANS HEARINGS ON PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

APRIL 1, 1993

Mr. Chairman and members of the Ways and Means Committee, I am pleased to be here as the newly elected Chairman of the Emergency Committee for American Trade to express the views of ECAT on the foreign tax proposals of the President's deficit reduction package.

I am also Chairman and Chief Executive Officer of Abbott Laboratories, a worldwide, diversified health care company with annual worldwide sales of nearly $8 billion and 48,000 employees.

Let me first say that I and my colleagues in the business community welcome President Clinton's attention and proposals to reduce the burgeoning federal budget deficit. It is the nation's number one economic problem. We can and do argue with some of the deficit reduction proposals. What we do not argue with is the necessity to get on with the deficit reduction task.

Trying to put myself in your places as legislators charged with approving deficit reduction measures, I can imagine that it is easy for you to get frustrated with witnesses like myself who, while supportive of the objective of reducing the deficit, object to some of the proposed means to accomplish the desired end. In the case of ECAT, our objection is to some of the proposals to levy increased U.S. taxes on the foreign source income of American firms.

I recognize the need to increase revenue, and I in no way object to paying a fair share of increased taxes on my own income as part of the collective effort to bring our national budget into better order.

As the steward of Abbott Laboratories, however, with responsibility for the jobs of 48 thousand Abbott employees and a share of responsibility for the well-being of the many communities around the United States in which our laboratories, factories, offices, and other facilities are located, I do object to the Administration's foreign tax proposals since they are arbitrary and uncompetitive.

These proposals, for example, single out U.S. firms with overseas business operations for payment of an unduly heavy share of the additional tax burden called for in the deficit reduction package. For reasons that I will later cite in connection with an ECAT study of the impact of U.S. overseas business on the U.S. economy, we think this an unwise course of action.

While we in the business community recognize that the new Administration needs time to develop a set of consistent foreign economic policies, we hope that the chosen path will be toward opening such competitive opportunities as those that will follow successful completion of the long-stalled Uruguay Round and the NAFTA rather than a path of placing U.S. business in less favorable competitive situations such as would follow enactment of the

foreign tax proposals before this Committee. If we are to survive and prosper in the modern global economy, we cannot afford to see our streams of income diminished, as would be our foreign income stream with enactment of President Clinton's foreign tax proposals.

Before talking more specifically about these foreign tax proposals, I would like to talk for a few moments about the context in which President Clinton has presented them to the Congress and to the public.

The rhetoric of the campaign and the early weeks of the new Administration depict the U.S. tax code as somehow or other unduly encouraging U.S. firms to invest abroad rather than at home. Were reality coincident with the rhetoric, I would find it difficult to disagree with proposals intended to make taxes a neutral factor in regard to where investments are placed.

But the rhetoric does not fit the facts. The U.S. tax code does provide investment neutrality. In order to avoid double taxation of the same income, the foreign tax credit provides that income earned abroad by U.S. citizens shall pay the higher of either the U.S. tax rate or the foreign tax rate. If the foreign rate is higher, then no tax is owed the United States. If the foreign tax is lower , then the difference between the foreign and the U.S. rate is owed the United States.

When U.S. taxes are owed on foreign income, they are payable on receipt of the foreign earnings. In this way, U.S. taxes are paid on foreign income when it is realized just as U.S. shareholders pay tax on corporate profits only after dividends are received.

This practice of the United States is generally mirrored in the tax practices of other countries. As a result, there is an approximate international tax neutrality insofar as investment is concerned. To the extent that the United States tax practice diverges from the international norm, there is a competitive disadvantage to U.S. firms. I believe that several of President Clinton's foreign tax proposals move the United States away from the international norm and that they would, if enacted, be anticompetitive for U.S. business.

Anticompetitive measures cannot be afforded by the U.S. economy, which is more closely intertwined with the economies of our trading partners and our global competitors than is generally realized. We in ECAT, for example, are about to publish a study demonstrating the enormous benefits to the U.S. economy flowing from U.S. foreign direct investments.

The principal author of our study is Dean Peterson who is a respected and well-known international economist with extensive government and private sector experience. Dr. Peterson worked in close consultation with economists from a number of ECAT member firms. Our study has also been reviewed by other nationally known economists to help ensure that it contains no glitches.

We conducted our ECAT study to examine the effects of the foreign operations of U.S. multinational corporations on the U.S. economy. A similar ECAT study in the early 1970's had shown that the foreign direct investments of U.S. firms had a most positive effect on the U.S. economy. We wanted to see, in light of the relative deterioration of the U.S. international competitive

position during the 1980's, whether this positive effect might have changed since the original study was published in 1973.

Our study, therefore, focuses on the decade of the 1980's. It in very considerable depth explores the effect of U.S.-based multinational companies on the health and competitiveness of the U.S. economy. The study is based on an examination of U.S. government statistics, and demonstrates that U.S. multinational corporations continue to be a source of enormous strength to the U.S. economy in every measurable respect.

Let me summarize for you some of the most important findings. I believe it critical for national policy that these findings be clearly understood for they establish a factual framework against which policy proposals such as foreign tax proposals can better be weighed to see if they advance or detract from the national interest.

The ECAT study shows that U.S. multinational corporations (USMNCs) made strongly positive contributions to the U.S. trade, payments and financial positions throughout the 1980's, a decade characterized by a massive deterioration of the U.S. trade balance, international payments balance, and global financial position. In fact, USMNCs are now the single most positive factor in the U.S. balance of payments. Had it not been for the positive performance of USMNCs during the 1980's, the economic position of the United States would have been much worse, given the weaker performance of corporations oriented primarily toward the domestic market.

The report's principal findings are:

- USMNCs contributed surpluses to the U.S. balance of payments - consisting of positive trade flows and earnings net of reinvestment - averaging $83 billion annually in the period 1982 to 1990.

- USMNCs balance of payments surpluses rose steadily from an average of $74 billion during 1982 - 1984 to $130 billion in 1990.

- USMNCs surpluses on trade account alone rose from $46 billion in 1984 to $80 billion in 1990. By contrast, the overall U.S. trade balance for manufacturers deteriorated steadily through 1987 and hit a deficit of -$73 billion in 1990. Absent the enormous balance of payment surpluses of USMNCs, the state of the U.S. economy and balance of payments would have been truly calamitous.

- USMNCs have consistently achieved trade surpluses in most industrial sectors.

- Real U.S. export growth averaged 14 percent annually from 1986-1991, the highest for any five-year period in U.S. history.

- Total U.S. exports accounted for 89% of U.S. economic growth during 1989-91.

- USMNCs accounted for approximately two-thirds of U.S. manufactured exports.

- **U.S. firms and industries that have been most aggressive in expanding global investments have also been most successful in expanding both their U.S. exports and global market shares.**

- **Industries with the highest proportionate levels of foreign investment achieved the highest rate of export growth. Significantly, U.S. exports to overseas affiliates accounted for a steadily rising share of total exports by USMNCs and were strongly and positively correlated with growth in foreign affiliate sales. This demonstrates the importance of foreign investment by USMNCs. In effect, exports follow investment.**

- **While returning substantial trade and balance of payments surpluses to the United States, USMNCs continue to build their operations abroad primarily through reinvestment of overseas earnings.**

- **Investments overseas enable USMNCs to achieve global economies of scale, to assure access to foreign markets, and to sustain the worldwide research and development activities indispensable to maintaining competitiveness in an increasingly global environment.**

- **The higher the share of U.S. direct manufacturing investment in a foreign country, the more likely the U.S. is to have a merchandise trade surplus with that country.**

- **The relative paucity of U.S. direct investments in Japan, for example, is a major reason why U.S. exports to that country are relatively small.**

- **U.S. foreign affiliates predominantly serve foreign markets. The underlying motivation for foreign direct investment is to penetrate markets otherwise inaccessible to U.S. firms and then to protect or expand market share. Excluding Canada, only 8 percent of sales by U.S. foreign manufacturing affiliates were to the U.S. market in 1989.**

- **Financial transactions by USMNCs have consistently been positive. Indeed, they are now the most positive single factor in the U.S. balance of payments.**

- **Gross balance of payments investment income generated by USMNCs rose from $30 billion in 1982 to $72 billion in 1992.**

- **Net of reinvested earnings, the average contribution of positive investment flows, climbed from $19 billion annually in 1983-84 to $56 billion in 1992.**

- **The dramatic deterioration of the U.S. merchandise trade balance in the first half of the 1980's was driven by clearly identifiable macroeconomic forces.**

- **The most important factors were the overvaluation of the U.S. dollar, up 37 percent in real terms against 40 leading international competitors from 1980 to 1985, and rapid growth in U.S. domestic demand in 1982-85 relative to other industrialized countries. Similarly, the subsequent recovery in U.S. exports and dramatic**

improvements in the merchandise trade balance can be traced to a reversal in these macroeconomic trends. Had U.S. multinational firms not made foreign investments, the trade balance would have been much worse.

- USMNCs have been and continue to be the source of significant employment in the U.S. economy -- much of which is generated by foreign investment.

- During the 1980's, manufacturing USMNCs had a better record on employment than the typical large U.S. manufacturing firm. Because of the economic downturn and increased pressure from foreign competitors, employment by USMNC parents did decline slightly from 1982 through 1989. That decline, however, was substantially smaller than the decline in employment by Fortune 500 companies as a whole. Furthermore, manufacturing employment by foreign affiliates of USMNCs is declining, belying the belief that USMNCs are shifting U.S. jobs abroad.

The above findings factually contradict the conventional wisdom that USMNCs are harming the U.S. economy by shifting jobs abroad and importing cheaper products into the United States. In fact, the opposite is true. Investment by USMNCs abroad provides the platform for growth in exports and creates jobs in the United States.

These findings lead to important policy conclusions, including:

- An open system of global trade and investment is a necessary condition for assuring long-term prosperity of USMNCs and the U.S. economy;

- Foreign direct investment is indispensable as the means for gaining access to overseas markets and as a source of capital and technology dissemination;

- Multilateral approaches to international trade and investment problems are preferable; and

- The link between domestic policies and international economic performance is of critical importance to maintaining competitiveness and jobs.

However, there are clouds on the horizon. Foreign multinationals have overtaken USMNCs as leading sources of new foreign direct investment. Proposals have been put forward to limit the economic activities of foreign multinationals in the United States.

Likewise, as the U.S. economy continues its halting recovery and unemployment rates continue to be a concern, proposals have been put forward to limit the flexibility of USMNCs to invest abroad, such as President Clinton's foreign tax proposals.

Enactment of such limiting proposals could produce tragic results for the competitiveness of the U.S. economy. The proposals would curtail needed foreign capital for the U.S. economy and would limit the ability of U.S. firms to

compete with global firms from Japan, Germany, and elsewhere, who are increasing their global market share at the expense of domestic U.S. firms.

It is with the benefit of the ECAT study in mind that I conclude that enactment of the President's foreign tax proposals would be harmful to U.S. firms who do business internationally. This, incidentally, includes many thousands of firms who supply materials and components and services to other firms who export goods. Many or most of these supplier firms are unaware that they are participants in U.S. international business.

In the case of Abbott Laboratories, for example, the increasing costs and burdens of government laws and regulations, among other things, makes it economical for us to contract with outside firms -- most of whom are small -- for goods and services. I believe this also to be true for large numbers of other U.S. firms. Out-sourcing saves large companies mandated costs, for example, that in many cases do not apply to smaller firms, and is a very major reason for small business growth.

A principal stated objective of President Clinton is to encourage the growth of small businesses, as witnessed by his proposal for an investment tax credit. The President's proposals to target U.S. multinational corporations for disproportionate tax increases, however, will work very much in the opposite direction. To the extent that the largest U.S. firms are hurt, so will be their outside suppliers.

The President has proposed six changes in the foreign tax area that together would increase taxes on U.S. multinational firms by an estimated $15.8 billion over a period of six years. I remember the late Senate Everett Dirksen -- another Illinoisan -- saying that a billion here and a billion there and soon you have some real money.

For the firms that would have to pay $15.8 billion, that is an awful lot of real money -- money that otherwise could have been invested in job creation for large numbers of workers and that could have prevented the loss of business opportunities to our foreign and domestic competitors.

As I said at the outset of this testimony, such possible consequences trouble me and my business colleagues at a time when we are all struggling to become more competitive and to maintain our standings in the dynamic global economy.

I would now like to briefly comment on the six proposed changes in the taxation of foreign source income. The three most troublesome to the members of ECAT are those that would:

- treat royalties as passive income for foreign tax credit limitations
- amend Section 936 to limit the possessions corporation credit to 65 percent of wages paid, and that would
- eliminate foreign tax "deferral" for accumulated earnings that are greater than 25 percent of total assets.

While for a number of members of ECAT the Section 936 proposed changes treated below are of the greatest consequence, the proposed changes

concerning royalty income are either at the top of the list for a large number of ECAT companies or are a close second.

What is proposed by the Clinton Administration is to treat royalty income as passive income, thereby disallowing low-tax royalty income to be averaged with high tax income as currently provided under the overall limitation method of calculating the foreign tax credit. This will very substantially increase the tax costs of conducting foreign business for large numbers of U.S. firms who license technology to their overseas affiliates as well as to non-related firms.

Royalty income is an important component of U.S. international competitiveness. To illustrate, in 1991 royalty and licensing income from abroad totaled $17.8 billion. This large amount is not only vital to the profitability of the parent U.S. firms, but to the U.S. balance of payments.

The United States is fortunate in being a high-technology economy. Licensing this technology to overseas subsidiaries is important to the international competitiveness of both the subsidiary and the U.S. parent firm. To raise the tax costs of licensing technology seems inappropriate and unfair to high-technology firms who are doing their best to compete with the high-technology industries of other countries. To so penalize the licensing of technology as proposed by President Clinton will raise U.S. taxes on foreign source income at a time when U.S. industries are under siege from abroad. It might cause some to review whether it might not be more economical to conduct R & D in overseas facilities. Indeed, many countries offer incentives to attract the conduct of R & D in their jurisdictions.

It is interesting that the proposal to place royalty income in a passive basket is one part of a two-pronged proposal. The other prong is to provide that under the allocation provisions of Section 861 of the Internal Revenue Code, R & D expenses can be allocated solely to the locus of the R & D expenditure. While this is desirable, it in no way compensates for the substantial added tax burden connected with the royalty income prong.

The dual nature of this particular two-pronged proposal is troubling. While the Section 861 part is designed to keep R & D in the United States, the other part that would increase taxes on royalty income would do exactly the opposite, i.e., it would encourage U.S. firms to explore the possibilities of conducting R & D activities abroad.

As the head of a worldwide health care firm that has made considerable investments in Puerto Rico in large part on the basis of Section 936, I am particularly distressed at the proposed changes in that Section. I would hazard a guess that if enacted, there will be no federal budgetary saving or deficit reduction since it can be expected that in place of the private sector Section 936 investments there will be the need for increased direct federal transfer payments to meet a minimal level of societal benefits in Puerto Rico.

Local, state, and federal government transfer payments in the United States also might increase with the proposed drastic cutback in the Section 936 credit to the extent that there would be further migration from Puerto Rico to communities on the mainland that might not offer sufficient numbers of job opportunities, thus resulting in increased government transfer payments to the unemployed.

In addition to the increased federal, state, and local transfer payments that could be expected to follow from cutbacks in Section 936, it is also reasonable to expect that the government of Puerto Rico would exact a tax on Section 936 funds remitted to the mainland so that the estimated tax revenue estimates would likely be smaller than surmised. Also, if a truncated Section 936 causes U.S. firms to move their operations from Puerto Rico, they likely would go to other Caribbean or Pacific Rim countries.

The third most objectionable foreign tax proposal is to eliminate so-called "deferral" for retained earnings abroad that are in excess of 25 percent of the asset value of the foreign subsidiary. For many ECAT companies this is perhaps the most objectionable of the foreign tax proposals. It is but another attack against the "deferral" provisions in U.S. tax practice.

"Deferral" over the years has continually been whittled away by such measures as recharacterization of active income into passive income -- such as is similarly now being proposed for royalty income.

No other countries go through these kinds of excesses. They either practice "deferral" as the United States used to, or they don't use "deferral" since they do not levy national taxes on income earned overseas by their citizens.

What "deferral" simply does is to postpone the payment of taxes until the income has been received by the taxed entity. We follow the same practice domestically. Shareholders in U.S. firms do not pay personal income taxes on the non-distributed earnings of the corporations in which they hold shares.

Of the other three foreign tax proposals included in the President's deficit reduction plan our views are as follows:

- the "stripping" rule proposal is not of any significant interest to ECAT members

- on the proposal to eliminate the working capital exception for foreign oil and gas and shipping income, ECAT members believe that interest earned on necessary amounts of working capital should not be deemed to be passive income, and

- on the proposal to improve enforcement of the Section 482 arms-length pricing mechanism, there is ECAT agreement that improved enforcement is certainly non-objectionable.

We would hope, however, that any new enforcement rules for Section 482, or for any other measures, will not further complicate the enormous and stifling burden of compliance. The 1986 tax bill added such technicalities and administrative burdens as to be nearly non-administrable. For many of us, the cost of compliance is often greater than the resultant tax payment.

To conclude, I would ask you to weigh the proposed increases in taxes on foreign source income not just against possible revenue loss if they are not enacted, but also against their anti-competitive effect on U.S. firms engaged in foreign business. As our soon-to-be released ECAT study shows, these firms and their foreign business operations contribute most positively to the economic well-being of the United States. Their positive contributions far overwhelm any possible marginal tax revenues.

I would urge you to place these contributions uppermost among your considerations of the national economic interest in deciding on your deficit reduction legislative package. Prospering U.S. companies will pay more taxes than will diminishing ones.

Thank you.

Mr. BREWSTER. Thank you.
We will next hear from Mr. Farmer.

STATEMENT OF F. SCOTT FARMER, VICE CHAIRMAN, COMMITTEE ON TAXATION, U.S. COUNCIL FOR INTERNATIONAL BUSINESS

Mr. FARMER. Mr. Chairman, my name is Scott Farmer. I am a member of the law firm of Miller & Chevalier here in Washington, DC, and I am testifying today on behalf of the U.S. Council for International Business, of which I am vice chairman of the committee on taxation.

The U.S. Council represents a broad array of U.S., as well as foreign-owned, companies, all of which are impacted in some way or another by the international provisions that the President has proposed. We have submitted detailed written comments, and what I would like to do is focus on what we see as the most significant problems.

As many of the people today have testified, by far the most troublesome proposal for the U.S. Council is the proposal to treat active royalties as passive for foreign tax credit purposes. We strongly oppose this provision.

The main concern that we have is that our companies are not investing overseas to sell back into the United States or gain some kind of tax preference. The primary reason they are investing overseas is for business reasons. There is a need to be close to the customer, in order to avoid tariff and nontariff problems and transportation costs, and just to be responsive to the market. So it is not for tax reasons that they are investing overseas.

Moreover, we feel that increased foreign activities actually tend to increase U.S. employment and intend to increase the U.S. economic growth.

In addition, as you have heard testimony today, we feel this provision may cause some behavioral effects. Many companies are going to be faced with a significantly increased tax on their U.S. technology and they will have to consider operating through joint venture or branch operations. It may even cause certain companies to move their R&D operations overseas.

Finally, the royalty proposal has been coupled with a proposal to treat domestic R&D as sourced to the United States. We feel that those two provisions should not be combined or linked, but if that treatment continues, we would be in favor of abandoning both of the provisions, and continuing to pursue the R&E source rule through the regulation process. We feel the 64-percent solution currently is a reasonable solution.

I would also like to make just a few comments about the proposal to cut back on deferral and the proposal that would tighten the earning stripping provisions. We have basically three concerns with the proposal that would treat earnings of CFC's as being currently taxable to the extent that passive assets exceed 25 percent of the total assets of the CFC.

First, we think the proposal is likely to make U.S. companies less competitive. Second, we feel there is no data that suggests or analyzes the 25-percent threshold as being the correct threshold. We

feel that the 50-percent threshold of the PFIC provisions is an appropriate threshold.

Third, the proposal has a significant retroactive effect. As proposed, a company that made no investments after the enactment of the provision or, in fact, had no income, and lost money every year, could still be subject to the provision. We find this to be somewhat unprecedented in the Tax Code, and we feel it is unfair.

Finally, we are concerned that the earnings stripping proposal broadens the discrimination against foreign-owned companies by tightening the earnings stripping rules, which essentially apply only to foreign-owned companies.

We are especially troubled by the fact that the proposal may limit interest expense deductions on foreign-owned businesses borrowing from U.S. institutions, even though those U.S. institutions are paying full tax on their interest income. We find that possibility, at least in a broad array of situations, to go beyond what we believe was the intent of the earnings stripping provisions.

Thank you.

[The prepared statement follows:]

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

**COMMENTS ON
PRESIDENT'S REVENUE RAISING PROVISIONS
AFFECTING INTERNATIONAL BUSINESS**

I. INTRODUCTION

Among President Clinton's revenue-raising provisions are a number of provisions which would impact international business. Although the President seems to recognize the global nature of today's economy and the need to make U.S. business more competitive, many of these international proposals would have the opposite impact. The proposals would, in general, make it more costly for U.S. corporations to conduct business overseas and would set back efforts undertaken in recent years to simplify the international provisions of the Internal Revenue Code. Our comments on the specific international proposals are set forth below.

The United States Council advances the global interests of American business both at home and abroad. It is the American affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee (BIAC) to the OECD, and the International Organization of Employers (IOE). As such, it officially represents U.S. business positions in the main intergovernmental bodies, and vis-a-vis foreign business and their governments. The Council addresses a broad range of policy issues affecting an increasingly globally oriented American business community. Its objective is to promote an open system of world trade, finance, and investment.

II. PASSIVE ROYALTY PROPOSAL

The proposal would require businesses that develop patents, trademarks, proprietary know-how and other intangibles in the United States to include any overseas royalties they receive from these intangibles in their "passive income basket" even though these intangibles support an active business abroad.

In contrast to the proposal to increase the corporate tax rate, the Royalty Tax singles out for harsh tax treatment a relatively small number of companies that use

licensing arrangements, often out of necessity, as part of their active efforts to enter international markets with U.S. developed goods and services. In addition, the companies singled out are some of the most important contributors to U.S. exports and high-quality U.S. jobs.

A. U.S. Multinationals With Royalty Arrangements Are Not Exporting Jobs, Nor Are They Receiving A "Tax Preference"

U.S. multinationals invest overseas primarily to expand into and service new foreign markets, not to replace U.S. jobs or to gain a tax preference. High transportation costs, tariff and nontariff barriers, and the need to produce products responsive to the local markets often make U.S. production unfeasible. In fact, many U.S. multinational manufacturers which sell abroad would be forced to retreat from foreign markets altogether if it were not possible to conduct manufacturing operations through foreign subsidiaries.

Moreover, increased foreign business activity actually enhances the level of U.S. employment and overall U.S. economic growth. Sales by foreign affiliates tend to come at the expense of foreign competitors rather than U.S. exporters. U.S. foreign direct investment also tends to increase exports by increasing purchasing power (as a result of higher national income) and heightening the awareness of U.S. brands in foreign countries.

B. Adverse International Competitiveness Effects

The Code currently over-taxes foreign earned income because of the sourcing rules for interest, state income taxes, and R&E expenses. Adoption of the Royalty Tax proposal would significantly compound this effect. The Royalty Tax would also add a significant layer of complexity to the already overburdened foreign tax credit system. The net result would be to make U.S. multinationals less able to compete in foreign markets against foreign-based multinationals that do not encounter similar home-country tax burdens.

C. The Royalty Tax Abandons Sound, Well-Established Tax Policy Principles

Existing law already includes passive royalty income in the passive basket. The Royalty Tax would treat royalty earnings that are demonstrably active as passive income. The Royalty Tax also would arbitrarily change the character of earnings simply because they move through a controlled group of companies, and thereby create a distinction between branches and subsidiaries. Treating royalties as active income that may be averaged with other active income and maintaining parallel treatment between branches and subsidiaries are sound, well-established principles that should not be abandoned in search of short-term revenues.

D. The Royalty Tax Will Force U.S. Multinationals To Reexamine The Way In Which They Do Business

U.S. companies faced with increased taxes on U.S. technology caused by the Royalty Tax will have to consider reducing their U.S. R&D, and the good high-paying jobs it supports, in favor of operating through joint ventures or branches. Ironically, the Royalty Tax may even create an incentive for some companies to move their R&D and other operations offshore. Ultimately, the Royalty Tax will tend to cause U.S. companies to repatriate fewer earnings, thus reducing much needed capital for domestic investment, and potentially paying higher taxes to foreign countries.

E. The Royalty Tax Is Improperly Linked To An Unrelated Proposal To Support U.S. Research And Experimentation

The Administration has combined the Royalty Tax proposal with a proposal to source all domestic research and experimental ("R&E") expenses to the U.S. The sourcing of R&E expenses, however, has nothing to do with the active or passive nature of royalty income. The only connection is a theoretical one: that to the extent R&E expenses are deducted solely against U.S. sourced income, the U.S. should be permitted to tax income produced from the R&E activities without regard to foreign taxes on other foreign income.

The U.S. Council does not believe this theoretical connection justifies the problems that flow from the Royalty Tax. The full cost of the Royalty Tax is many times greater than the real benefit of the R&E sourcing rule. Moreover, many of the taxpayers hit by the Royalty Tax will receive little benefit from the R&E sourcing rule. On the other hand, the R&E sourcing rule will encourage U.S. R&D. The U.S. Council, therefore, strongly recommends that the R&E sourcing rule be enacted without regard to the Royalty Tax. But if the two continue to be linked, we favor continuing efforts for regulatory solutions to the R&E sourcing issue and abandoning the R&E provision and Royalty Tax altogether.

III. REQUIRE CURRENT TAXATION OF CERTAIN EARNINGS OF CONTROLLED FOREIGN CORPORATIONS

A. Current Taxation of Certain Earnings of CFC's

This provision would tax earnings of controlled foreign corporations (current as well as accumulated earnings) to the extent that the corporation's passive assets in any year exceeded 25 percent of its total assets. The U.S. Council opposes this provision. The U.S. already cast its taxing net more broadly than any other foreign country. Extending the U.S. taxing net even further only makes this worse. In the end, the U.S. suffers, because U.S. companies are less competitive.

The U.S. Council particularly objects to the retroactive nature of the provision. It applies to profits earned under an assumption by U.S. corporations that the tax law in effect at the time would not be changed -- that is, that such earnings would not be taxable in the U.S. until remitted as dividends (excluding subpart F income). At a minimum, therefore, the proposal should be modified to apply only to earnings earned after the date of enactment of the proposal.

Finally, the U.S. Council notes that this provision runs contrary to the tax simplification proposals passed by the Congress last year as part of the two-vetoed tax bills and

included in current bill H.R. 13. These bills eliminate the multiple anti-deferral regimes in favor of a single regime. The excess passive asset proposal would increase, rather than reduce, the anti-deferral regimes that U.S. multinationals must comply with in conducting business through foreign subsidiaries.

IV. ELIMINATE WORKING CAPITAL EXCEPTION FOR FOREIGN OIL AND GAS AND SHIPPING INCOME

This provision would redefine Foreign Oil and Gas Extraction Income and Shipping Income to exclude income from working capital, characterizing it as "passive income." More specifically, the bill would classify interest income derived from bank deposits or temporary investments of working capital as "passive income" to be treated separately for foreign tax credit limitation purposes.

The U.S. Council believes that present law, which includes interest income derived from working capital used in foreign oil and gas extraction or shipping operations as part of the same foreign tax credit basket as other foreign oil and gas extraction income or shipping income, is both reasonable and logical from a tax policy standpoint and should not be altered. In fact, the U.S. Council believes that Congress erred in 1986 when it generally excluded working capital interest income from the general income basket for foreign tax credit limitation purposes. Such interest is clearly an inherent part of the overall operations of a foreign trade or business and should not be treated differently from other active income. Accordingly, we not only oppose this provision but recommend that existing law be modified to treat all working capital income as part of the general income basket for foreign tax credit limitation purposes.

V. TRANSFER PRICING PENALTY INITIATIVE

The U.S. Council's primary concern with this proposal is that taxpayers be protected from the penalty if they have a good faith belief, supported by documentation, that they were applying a reasonable pricing methodology, even

if the IRS later determines that a different method was the "best method."

As the degree of documentation required is dependent upon provisions in the recently issued Temporary and Proposed Regulations under Section 482, the type of documentation required will not be made clear until those proposals are finalized. At a minimum, therefore, the penalty provision may be premature and may be unnecessary as the matter is currently being handled through regulation.

VI. EARNINGS STRIPPING

The U.S. Council is concerned that the earnings stripping provision broadens the discrimination against foreign-owned businesses by tightening the thin capitalization rules which are essentially applicable only to foreign-owned U.S. companies. The U.S. Council is especially troubled that the provision may limit the interest expense deductions to foreign-owned businesses borrowing from U.S. institutions who are fully taxed on their interest income. As such, the provision would go well beyond the original intent of the legislation to defer or deny interest deductions on payments to "tax exempt" lenders.

Mr. BREWSTER. Thank you, Mr. Farmer.
Next will be Mr. Foster.

STATEMENT OF J.D. FOSTER, CHIEF ECONOMIST AND DIRECTOR, TAX FOUNDATION

Mr. FOSTER. Thank you, Mr. Chairman and members of the committee.

My name is J.D. Foster, and I am chief economist and director at the Tax Foundation. It is an honor to appear before the committee today to discuss President Clinton's proposals for public investment, deficit reduction, and international competitiveness.

The Tax Foundation is a nonprofit, nonpartisan research and public education organization that has monitored national fiscal policy since 1937. We have approximately 600 members, consisting of businesses, charitable foundations, and individuals. We are here today to promote sound fiscal policy conducive to improved international competitiveness.

Mr. Chairman, for a change of pace, I am going to try and put the President's program as it relates to international competitiveness into an economic context and leave the detailed discussion to my written statement and to my fellow members of this and previous panels.

We have really one central economic problem in this country today, which is low productivity growth. Raising productivity is at the heart of improving our international competitiveness. Productivity grew at about 2.4 percent from 1959 to 1969, 1.3 percent from 1969 to 1979, and .8 percent from 1979 to 1989, and this general pattern has been repeated in most of the major industrialized nations. It is not unique to the United States.

Now, even though slow productivity growth is international, some Government actions can increase our productivity growth and enhance our competitiveness. These include increasing national saving, reforming our Tax Code to be less punitive to saving and investment, reducing the high costs of Government regulation, reducing the size of Government at all levels, and reducing the time business men and women spend trying to understand the latest changes or interpretations of the Tax Code.

We must raise our productivity faster in the next 20 years than in the past 20 years if we are to remain competitive. The question at this juncture is: Does deficit reduction, relying on very large tax increases, defense spending cuts, and a reshuffling of domestic spending offer any hope of addressing our productivity problems? Sadly, sir, it does not.

Tax policy alone does not control our economic future. Even perfect tax policy will not guarantee prosperity if we make enough other mistakes, any more than an all-star shortstop can take a team to the World Series, if the rest of the players are error-prone.

But tax policy can contribute to higher productivity, primarily by getting out of the way, getting the tax disincentive out of saving and investing and business formation and risk-taking.

President Clinton's program, like its predecessor, the 1990 budget deal, will slow productivity growth, not enhance it. While the budget processes may be smoother in 1993, the fact is the two are strikingly similar. Both feature enormous new taxes, both reduce

defense spending below baseline projections, and the 1990 budget deal allowed total nondefense spending to increase by 29 percent in the first 3 years. President Clinton's program holds the rate of nondefense spending increases in the first 3 years to only 14 percent, so that is an improvement. Of course, this assumes all projected spending cuts are made and no new spending programs are enacted.

One other similarity: Each will have a successor of like design and size. Mr. Chairman, 2 or 3 years from now, this committee will be holding this same hearing again, the words spoken today still echoing. As Yogi Berra said, "it's deja vu all over again."

This is, in fact, the seventh attempt at tax-based deficit reduction since 1982. The facts are plain. The results are in. Tax-based deficit reduction is fiscal alchemy, it just won't work.

President Clinton ran on the need for change. In this case, at least, I wish he meant it, because history shows that this program doesn't offer change. It offers business as usual, and, as usual, it fails to address our basic economic problems such as raising productivity, putting off for tomorrow what we should have done yesterday.

In economic terms, the deficit is a bad, and as Federal Reserve Chairman Greenspan recently told the Senate Finance Committee, taxes are not good in themselves, they are bad. And just as two wrongs do not make a right, Mr. Chairman, if you will excuse the pun, two bads produce no goods.

If the deficit is bad and tax increases are counterproductive, and we are serious about getting productivity up and our international competitiveness up, maybe we ought to try cutting spending.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Statement of Dr. J.D. Foster
Chief Economist and Director
The Tax Foundation

on

President Clinton's Proposals
For Public Investment and Deficit Reduction

Mr. Chairman and Members of the Committee, my name is J.D. Foster and I am Chief Economist and Director of the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss President Clinton's proposals for public investment and deficit reduction.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937. We have approximately 600 members, consisting of large and small corporate and non-corporate businesses, charitable foundations, and individuals. Our business membership covers practically every region of the country and every industry category. The reason for our appearance today is to promote sound fiscal policy.

As with any program the size of that proposed by President Clinton, there are good points and bad points. For example, making permanent many of the transitory provisions of present law, such as the research and experimentation tax credit and the low-income housing tax credit, represents good tax policy because, among other things, it brings more certainty to the tax law. Businesses and individuals simply cannot undertake long-term planning with any confidence when there is continued uncertainty in the tax law.

In contrast to its many good provisions, President Clinton's plan also proposes major tax increases for individuals and corporations. President Clinton's call for net tax increases of $274 billion over the next five years through explicit taxes and another $32 billion in various user fee increases, for a total $309 billion net increase, comes at a time when American taxpayers are already shouldering the heaviest tax burden in U.S. history.

Mr. Chairman, let me begin by placing the President's program in economic context. We really have one central economic problem in this country today -- one problem that either captures the effects of other problems, or is itself the cause of the other problems: Low productivity growth.

Whether your main concern is wage growth, job growth, international competitiveness, or the futures we leave to our children, it all boils down to increasing productivity.

Productivity, measured as output per hour of all persons in the nonfarm business sector, grew at about 2.4% between 1959 and 1969, slowed to 1.3% from 1969 to 1979, and slowed further to 0.8% between 1979 and 1989. This general pattern has been repeated in most of the major industrialized nations.

Some of the slow productivity growth is demographic in nature. As the baby boomers entered the work-force it shifted the balance of skills to relatively less-skilled workers. The same occurred as the percentage of women entering the labor force increased. New entrants typically have fewer skills, and lower productivity, than more experienced workers. Eventually this surge of less-skilled workers will produce a surge of highly-skilled, experienced workers and improvements in living standards should accelerate.

There are a host of other reasons for the slower productivity growth, however, which do not appear to be self-correcting, including

- the shift to more service-oriented industries,
- the high costs of government regulation,
- the increase in the size of government at all levels, draining resources from the private sector,
- the low national savings rate,
- the enormous time our businessmen and women spend defending themselves from frivolous lawsuits,
- and the time they spend trying to understand how the latest changes or interpretations of the tax code are going to affect their next investment.

We know that we need to raise our standard of living more rapidly in the next 20 years than in the past twenty years. The question we must ask ourselves at this juncture is: Does a deficit reduction program relying on very large tax increases, defense spending cuts, and a reshuffling of domestic spending programs offer any hope of addressing our productivity problems?

Sadly, Mr. Chairman, it does not.

Tax policy is just one of many influences on our economy. Even a perfect tax policy on economic efficiency grounds will not guarantee prosperity if we make enough other mistakes, any more than an all-star short-stop can take a team to the World Series if the team has no pitching.

Nevertheless, tax policy can contribute to higher productivity growth in many ways, most of which can be summed up by simply getting out of the way. Tax policy can best contribute to higher productivity by getting the tax disincentives out of saving, investing, business formation, and risk taking.

Take saving, for example. Tax-based deficit reduction may increase total national saving by reducing government dissaving, but only if the taxes raised do not reduce private saving by more than the amount of deficit reduction.

While there is much we do not know about how the President's tax proposals will affect the economy, there are a few things we do know. First, we know the tax increases will slow the economy. The only offsetting effect, a possible slight reduction in interest rates, will almost certainly be swamped by the tax increases' disincentive effects. A slower economy means reducing the savings base, as well as the tax base.

We also know that most of the private saving in the U.S. is done by upper-income individuals and corporations. If you want to increase the rate of saving, you must either let those who are likely to save keep more of their money, or you must reduce the disincentive to save facing the rest of us.

Sadly, the Clinton program has passed-up the opportunity to encourage low- and middle-income Americans to increase their saving. There is not one provision in the President's plan to help these families increase their saving.

By raising tax rates on the rich and corporations, the President's plan has specifically targeted for higher taxes those people most likely to save. The Clinton program is likely to reduce both the rate of saving per dollar of income and the rate of economic expansion, thereby assuring a reduction in private saving which may exceed the amount of actual deficit reduction.

President Clinton's budget program, like its most immediate predecessor, the 1990 Budget Deal, will further slow productivity growth, not enhance it. It will slow saving, investment, business formation, and job growth.

While the process by which the budget is enacted may be much smoother in 1993, the fact is there are a great many similarities between President Clinton's program and the 1990 Budget Deal. Both featured enormous new taxes. Both reduced defense spending below baseline projections. The 1990 Budget Deal allowed total non-defense spending to increase by nearly 29% in its first three years. President Clinton's program is better in this regard, it holds the rate of non-defense spending increases in the first three years to only 14%. Of course, this figure for the Clinton plan assumes all projected spending cuts are made and no new spending programs are enacted.

Perhaps the most disheartening similarity between President Clinton's program and the 1990 Budget Deal is that each will have a successor of like design and size. Mr. Chairman, just as sure as Winter follows Fall, two, maybe three years from now this committee will be holding this same hearing again, the words spoken today still echoing. As Yogi Berra said: It's deja vu all over again.

This is, in fact, the 7th such effort at tax-based deficit reduction since 1982. I have always believed in the expression: If at first you don't succeed, try, try again. But there comes a point where even the most committed, most tireless advocate must ask himself, what am I doing wrong?

President Clinton ran on the basic idea that it was time for a change. He titled his February booklet "A Vision for Change For America". In this case, at least, I wish he meant it. Because history shows clearly that the program before us does not represent change. It represents business-as-usual. And, as usual, it fails to address our basic economic problems -- saving, investment, higher productivity, better international competitiveness -- putting off for tomorrow what we should have done yesterday.

Deficit reduction is important for many reasons. As a matter of tax policy, the deficit has greatly hindered efforts to reform our tax system to prepare for the competition of the 1990s and the next century. Every attempt at reform either dies on the vine or is turned into an opportunity for raising taxes further. Chairman Rostenkowski has worked hard to make a number of reforms that would simplify the tax code. Each time, the deficit makes the climb that much steeper.

As a matter of fiscal policy, the deficit diminishes our prospects for long-term prosperity. In economic terms, the deficit is a bad. And, as Federal Reserve Chairman Greenspan recently told the Senate Finance Committee: Taxes are not a good in themselves. They are a bad.

Just as two wrongs don't make a right, Mr. Chairman, two bads produce no goods.

Now, Mr. Chairman, I would like to address some of the specific aspects of the President's program that the Tax Foundation finds troubling.

Family Tax Burden

President Clinton has proposed tax increases that will significantly boost the tax burden of working, middle-income families. Even without taking into account this potential increased tax burden, Federal, state, and local taxes already represent the largest item in the typical American family's budget. In 1992, the average American family spent 39.7 percent of its budget on taxes -- more than on food, clothing, and housing combined. After discharging its tax burden and purchasing the necessities of life, the typical family had only 29 cents left out of each dollar to pay for such items as health care, transportation, and insurance, and to save for the future.

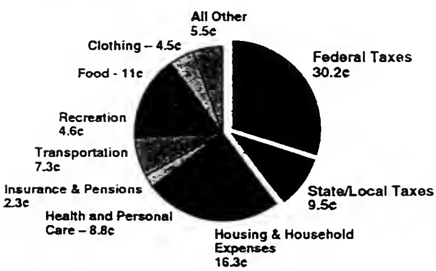
Notwithstanding significant Federal individual income tax reductions in 1981 and 1986, income tax relief for the typical family has been overwhelmed by the rising toll of Social Security taxes, Federal excise taxes, and state and local taxes. The bulk of the family's tax savings from income tax reductions in the 1980s were offset by the rapid growth in Social Security taxes. Since 1980, the Social Security tax has increased six times -- from 12.2 percent to 15.3 percent. Because of these tax increases, coupled with annual increases in the Social Security wage base, the Social Security tax took $8,260 out of a typical family's income in 1992, half directly and half through the employer's share of the FICA tax.

Business taxes and numerous excise taxes on such items as gasoline, liquor, tobacco, and telephone use also take a significant portion of the family's earnings. Business taxes result in lower wages and salaries for workers, higher prices for the products and services they consume, or reduced returns on the family's savings and investments. The median-income family paid an estimated $1,702 in total indirect Federal taxes in 1992 -- or 3.15 percent of its income.

The growth in taxes levied by state and local governments has also accounted for part of the decline in the family's after-tax income. Since 1990, states have added an additional $42 billion in new taxes. Total state and local taxes, which claimed 8.9 percent of the family's total income in 1982, take 9.8 percent (or $5,282) of the typical family's earnings today.

The following charts illustrate the typical family's tax burden:

Taxes Dominate Family Budget



1992	Dollar Amount	Percent of Income
Family Income	53.984	100.0%
Total Taxes	21.445	39.7
Federal	16.163	29.9
State and Local	5.282	9.8
After-tax Income	32.539	60.3
Total Personal Consumption Expenditures	32.539	60.3
Housing and Household Expenses	8.795	16.3
Food and Tobacco	5.935	11.0
Health and Personal Care	4.750	8.8
Transportation	3.940	7.3
Recreation	2.482	4.6
Clothing	2.428	4.5
Insurance and Pensions	1.241	2.3
All Other	2.968	5.5

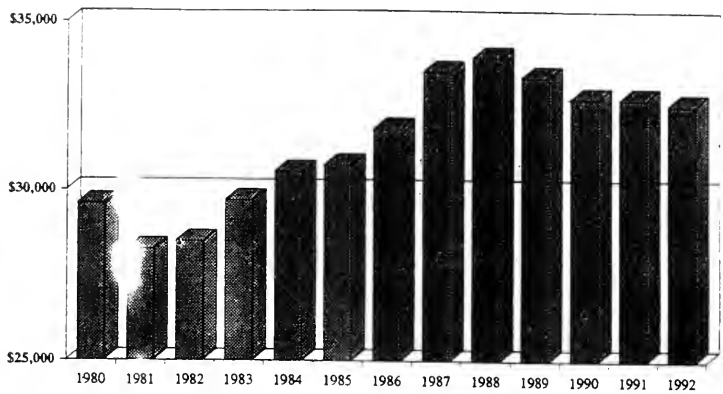
This example uses a median two-earner family earning $53,984 per year with two dependent children.
Source: Tax Foundation

Typical Family Losing Ground To Taxes and Inflation 1980–1992

		Federal Taxes						After-Tax Income		
		Direct Taxes								
Year	Two-earner median family income (e)	Income Tax(b)	Social Security	Indirect Taxes (c)	State & Local Taxes (d)	Total Taxes	Effective Rate	Current Dollars	Constant 1992 Dollars (e)	Real Income Gain or (Loss)
1980	$29,669	$4,849	$1,819	$3,076	$2,547	$12,291	41.4%	$17,378	$29,589	
1981	32,283	5,610	2,147	3,466	2,763	13,986	43.3	18,297	28,241	($1,348)
1982	33,492	5,219	2,244	3,457	2,985	13,905	41.5	19,587	28,477	237
1983	35,440	4,991	2,374	3,802	3,187	14,353	40.5	21,087	29,704	1,227
1984	38,267	5,497	2,675	4,028	3,435	15,639	40.8	22,628	30,555	852
1985	40,213	5,785	2,835	4,380	3,632	16,632	41.3	23,581	30,747	192
1986	42,326	6,123	3,026	4,434	3,691	17,474	41.2	24,852	31,813	1,066
1987	44,981	5,655	3,216	4,833	4,149	17,853	39.6	27,128	33,504	1,691
1988	47,445	5,828	3,563	5,148	4,293	18,832	39.6	28,613	33,934	430
1989	49,058	6,178	3,684	5,264	4,462	19,588	39.9	29,470	33,344	(590)
1990	50,898	6,562	3,894	5,311	4,646	20,413	40.1	30,485	32,724	(620)
1991	52,579	6,383	4,022	5,552	4,871	20,828	39.6	31,751	32,707	(17)
1992	53,984	6,201	4,130	5,832	5,282	21,445	39.7	32,539	32,539	(168)

a) Median family income for household with two earners, employed full-time, year round
b) Married couple filing joint return two dependent children
c) Estimated average indirect federal taxes Includes all excise taxes, employer's share of Social Security taxes, allocated corporate taxes, and miscellaneous levies
d) Estimated national average of total state and local taxes
e) Adjusted by Consumer Price Index (CPI-X1)
Sources Tax Foundation, U S Department of Commerce Bureau of the Census and Bureau of Economic Analysis, U S Department of Labor Bureau of Labor Statistics U S Treasury Department, Internal Revenue Service

Real Family Income After Taxes



Income after taxes in 1992 dollars. Source: Tax Foundation

President Clinton's proposal for a broad-based energy tax based on British thermal units, or BTUs, would have a significant impact on middle-income families. This $71 billion (1994-98) energy tax would cost the typical American family $471 per year according to Department of Energy consumption data. Moreover, the true burden of a BTU tax generally would be hidden from consumers and investors -- making it easy to increase in the future.

Chart 1 shows the breakdown of the BTU tax burden by family income class. Chart 2 presents estimates of the relative burden that a BTU tax would impose by state and by industry group within each state.

Chart 1
Distribution of Clinton BTU Tax

Family Income	Average Annual BTU Tax as a % of Income
Less than $10,000	1.72%
10,000 - 20,000	0.93
20,000 - 30,000	0.71
30,000 - 40,000	0.56
40,000 - 50,000	0.49
More than $50,000	0.32

Source: Consumer expenditure survey data and Tax Foundation computations.

Average Annual Btu Tax Burden by Sector by State
($Millions)

State	Residential Sector	Rank	Commercial Sector	Rank	Industrial Sector	Rank	Transportation Sector	Rank	TOTAL	Rank
Alabama	$49.8	22	$29.2	26	$126.8	9	$70.9	19	$276.6	17
Alaska	8.5	46	10.5	41	53.1	29	30.3	35	102.3	36
Arizona	35.1	30	36.7	20	32.1	37	57.4	25	161.2	29
Arkansas	28.3	33	18.0	34	50.9	30	40.3	33	137.6	33
California	224.7	1	229.0	1	332.5	3	499.7	1	1,285.8	2
Colorado	36.2	27	40.3	17	36.4	35	47.7	30	160.7	30
Connecticut	39.1	26	30.3	24	23.2	41	36.2	34	128.8	34
Delaware	7.9	47	5.9	49	16.5	45	11.1	48	41.4	47
Dist. of Col.	5.8	50	13.5	38	5.8	50	4.8	51	29.8	50
Florida	142.0	5	121.5	4	75.0	23	199.8	3	538.3	8
Georgia	76.1	11	56.7	13	111.9	15	120.2	10	364.9	12
Hawaii	4.4	51	7.9	44	12.7	46	27.6	36	52.6	45
Idaho	13.1	40	12.2	39	24.3	40	16.0	42	65.6	41
Illinois	146.1	4	114.1	5	210.9	6	151.0	5	622.0	6
Indiana	72.5	12	47.0	16	208.0	7	102.1	13	429.6	10
Iowa	35.7	29	23.9	31	57.5	28	41.1	31	158.2	31
Kansas	31.5	31	28.7	29	71.4	25	49.6	29	181.3	26
Kentucky	44.8	24	30.1	25	114.6	13	66.3	20	255.9	19
Louisiana	51.3	21	37.7	19	399.7	2	126.0	9	614.8	7
Maine	14.0	38	10.2	42	19.4	43	20.3	41	63.9	42
Maryland	54.1	19	28.7	28	72.6	24	58.2	24	213.7	24
Massachusetts	68.1	14	58.4	12	38.3	33	71.2	18	236.0	22
Michigan	117.7	8	83.0	8	160.7	8	119.6	11	481.0	9
Minnesota	52.7	20	34.0	22	85.7	19	59.5	23	231.9	23
Mississippi	29.4	32	18.4	33	64.9	26	52.1	27	164.8	27
Missouri	65.5	16	49.9	15	60.8	27	83.5	16	259.7	18
Montana	10.3	43	8.9	43	25.7	39	14.6	44	59.5	43
Nebraska	21.0	35	19.2	32	22.8	42	26.6	37	89.4	38
Nevada	14.5	37	12.0	40	19.1	44	23.3	40	68.9	40
New Hampshire	12.3	41	7.2	46	10.5	47	12.6	45	42.7	46
New Jersey	82.8	9	82.6	9	92.2	17	140.1	8	397.7	11
New Mexico	13.2	39	16.6	35	34.9	36	40.5	32	105.1	35
New York	167.1	3	178.3	2	122.9	12	162.4	4	630.8	4
North Carolina	77.7	10	58.4	11	112.0	14	94.6	15	342.8	14
North Dakota	8.7	45	6.8	47	26.9	38	11.5	47	54.0	44
Ohio	137.4	7	101.1	6	272.1	4	140.1	7	650.7	3
Oklahoma	45.2	23	33.9	23	98.3	16	60.5	21	237.9	21
Oregon	35.7	28	28.8	27	49.1	31	49.7	28	163.3	28
Pennsylvania	140.3	6	91.1	7	246.8	5	148.3	6	628.3	5
Rhode Island	10.6	42	7.2	45	8.3	49	10.1	49	34.3	49
South Carolina	40.9	25	28.2	30	86.7	18	54.3	26	210.1	25
South Dakota	9.2	44	5.5	50	9.5	48	11.6	46	35.8	48
Tennessee	65.4	17	34.9	21	126.7	10	81.4	17	308.5	16
Texas	200.6	2	173.2	3	986.8	1	363.3	2	1,723.9	1
Utah	17.2	36	14.7	37	37.3	34	26.3	38	95.5	37
Vermont	6.7	48	4.2	51	4.0	51	7.4	50	22.3	51
Virginia	71.3	13	65.4	10	84.3	20	102.3	12	323.3	15
Washington	66.0	15	50.9	14	126.0	11	100.8	14	343.7	13
West Virginia	22.0	34	15.2	36	79.1	22	25.6	39	141.9	32
Wisconsin	59.0	18	40.3	18	81.1	21	60.0	22	240.3	20
Wyoming	6.0	49	6.7	48	42.8	32	14.8	43	70.1	39
United States	$2,795.8		$2,287.2		$5,252.2		$3,964.7		$14,280.0	

Source: Tax Foundation computations using U.S. Department of Energy Consumption Data.

Tax Fairness

President Clinton's economic plan contains a number of proposals intended to assure that higher-income individuals bear a heavier tax burden. The rationale for these proposals is that higher-income taxpayers do not currently pay their fair share of income taxes.

Several facts should be considered before concluding that the Federal income tax burden in the United States is not distributed fairly. For example, based on 1990 tax return data from the IRS, the top ten percent of income earners paid 53.9 percent of all Federal individual income taxes. In 1980, this group bore 48.6 percent of total individual income tax liability. The share of the tax burden borne by the top five percent of income earners grew by 17 percent over the past decade, from 36.4 percent in 1980 to 42.9 percent in 1990.

At the lower end of the spectrum, the bottom 50 percent of income earners saw their share of income taxes decline from 7.4 percent in 1980 to 6.2 percent in 1990. The average tax rate in 1990 ranged from 4.5 percent for the bottom 25 percent of income earners to 21.1 percent for the highest five percent of income earners.

What the numbers above demonstrate is that, notwithstanding arguments that the benefits of the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986 went mostly to the wealthy, tax policies during the 1980s maintained the progressivity of the Federal income tax system, as higher-income individuals continued to pay an increasing share of taxes. Broadening the tax base, reducing tax rates, and encouraging upper-income taxpayers to leave their tax shelters raised their share of the total Federal tax burden -- just as predicted.

The personal income tax is, of course, not the only source of revenue to the Federal government. The Federal government also levies various excises which are generally regressive forms of tax. However, the importance of excise taxes as a group has declined steadily from 8.1% of Federal receipts in 1970, to 4.7% in 1980, to 4.2% in 1992. The Federal government also imposes a highly progressive gift and estate tax and a corporate income tax that is probably a progressive tax. No changes in either of these taxes have been enacted recently to change their contribution to the progressivity of the overall Federal tax system.

The final remaining significant source of revenue is the payroll tax. The payroll tax, however, is part of an inter-generational tax and transfer system -- in effect, a combination of a tax and a negative tax system. Thus, even though the tax is regressive, the overall program is highly progressive because the progressivity of the transfer, or negative tax, portion of the program is greater than the regressivity of the payroll tax.

Consequently, the overall Federal tax system is highly progressive, due largely to the progressivity of the individual income tax, and has become more progressive in recent years.

International Competitiveness

One of the principal tenets of the Tax Foundation is that the U.S. tax system should provide an environment in which U.S. businesses can compete successfully with businesses of other industrialized nations. The Tax Code should not impede the free flow of goods, services, and capital. Clearly, the United States has through its tax policy frequently placed its own multinational corporations at a disadvantage by imposing more severe restraints and heavier tax burdens on foreign-source income than have several of its trading partners. Moreover, the frequent changes in, and complexity of, the tax law can be a disadvantage to our multinationals because of the high cost of tax compliance and added uncertainty.

The BTU Tax and Corporate Rate Increase

Both the proposed corporate income tax rate increase and the BTU tax as it applies to businesses are direct assaults on our international competitiveness.

It is often claimed by advocates of these taxes that businesses will simply pass them along to their customers in the form of higher prices. These claims are dubious, at best. Whether the business is domestic or foreign, competition in the global marketplace is fierce and getting more so. The economies of our major international competitors are struggling and their companies are working hard to expand market share and profit margins, particularly on export sales.

If a U.S. company were to try to raise its prices to pass along a BTU tax, for example, it would very quickly lose market share to foreign companies happy to receive the windfall. Raising prices in this environment is simply not an option for most companies.

Nor can or will most businesses reduce their payments to the owners. A funny thing about business owners, if they have an alternative to reducing their own income they will usually take it. Business owners, in fact, often have two alternatives. They can reduce capital investment and they can reduce employment and wage growth. Neither of these results advance the goal of improving our international competitiveness.

International Provisions

Over the past several years, while expressing support for the integrity of legal foreign corporate entities, the U.S. has driven the tax code further and further into the foreign operations of its multinational businesses. This ongoing effort to bring more revenues into the net of current taxation and to restrict the usefulness of the foreign tax credit represents an incremental abandonment of the fundamental principle of international taxation: avoiding double taxation.

Uncertainty is the nemesis of investment. Investors, whether private or corporate, whether investing at home or abroad, take great pains to eliminate all unnecessary risks from their investments and to gauge the remaining risks accurately to ensure that the projected return is commensurate with the degree of the project's risk.

A significant disadvantage for U.S. multinational companies has been the instability of the U.S. international taxation system. Every year or two for the past twenty years, the system has been changed in some way or changes have been threatened.

This continuous change in the tax code confounds tax professionals trying to guide business planners through the tax code both because the existing tax code and regulations are poorly understood, and because future changes, presently unpredictable, can dramatically change the financial condition of a proposed investment.

Thus, not only are U.S. multinationals effectively subjected to heavier tax burdens on foreign income than many of their competitors, but their ability to do long-term business planning also has been hampered severely, thereby raising the uncertainty surrounding their investments.

In the end, many investments simply are not made, even though they would otherwise yield a satisfactory return, because they cannot produce enough income to cover all their costs plus the premium that must be charged to tax uncertainty.

There are several proposals in President Clinton's economic plan that would affect our system of international taxation. These proposals would affect the working capital exception for foreign oil and gas shipping income, transfer pricing, research and experimentation expenditures, royalty income, earnings stripping, and deferral of income.

The repeal of deferral of tax for so-called excessive accumulated foreign earnings could have a significant impact upon the international activities of U.S. multinational firms. Many companies utilize a foreign holding company as the base for their international operations. Under present law, active income earned abroad through a subsidiary generally is not taxed until it is repatriated.

President Clinton's proposal would tax a company on so-called excessive accumulations of capital regardless of dividend payments. The definition of excessive accumulated foreign earnings would be based on a percentage of assets calculation. If more than 25 percent of a controlled foreign corporation's total assets were passive, then the amount of excessive accumulated foreign earnings would be the lesser of the amount of current year and accumulated earnings or the passive assets over the threshold of 25 percent of total assets.

For example, if a company had $100 of assets, $45 of which represented passive assets, and $15 of accumulated earnings, the excessive accumulated earnings that would be subject to current taxation would be $15. This proposal would add an additional layer of complexity to an already extremely complex area of the tax law and reduce the ability of U.S. multinationals to compete abroad.

Under present law, royalty income can be placed into the active income basket if the royalties relate to an active trade or business. Another proposal in the Clinton program that would be disadvantageous to U.S. multinationals would place all royalty income in the passive income basket for purposes of the foreign tax credit computation. This proposal could significantly affect U.S. companies that are required to establish royalty agreements with their controlled foreign corporations, under Code Section 367, for the transfer of intangible assets. While these assets normally are used to generate active earnings, the royalty income would be classified as passive. The increased taxation of earnings from licensing would adversely affect the competitiveness of U.S. multinationals. It could also result in increased imports of technology and, thus, exports of associated jobs.

The enactment of these proposals most likely would result in the increase of the overall effective tax rate for U.S. multinationals at a time when most U.S. companies are already struggling to compete globally. Accordingly, any additional revenue generated for the Federal government through these provisions could well be offset by a loss of global revenues for U.S. companies.

In contrast to the proposals discussed above, President Clinton's proposal to allocate 100 percent of research and experimentation expenses to the place of performance of the research and experimentation would simplify current law significantly and would reduce the compliance costs associated with this constantly changing area of the law. As the Treasury Department points out, enactment of this proposal also likely would encourage firms to conduct research and experimentation in the United States.

One of the most pro-competitive actions the Congress could take would be to preserve the corporate income tax rates enacted by the Tax Reform Act of 1986. Since 1986, most of our trading partners have followed the lead of the United States and have reduced their own corporate tax rates. To raise U.S. rates now would increase the tax burden of U.S. exports and the tax advantage of imports.

Conclusion

The new Administration is to be complimented for quickly producing a plan to reduce the Federal budget deficit. The economy is growing at a steady pace, inflation is low, and the ongoing adjustments to the reductions in defense spending seem to be the only significant disruptions to the normal flow of economic activity. Therefore, any disruption to the economy from reducing the deficit, per se, is not likely to disrupt the economy sufficiently to cause a recession.

Whether deficit reduction ultimately serves to improve long-run economic performance or not depends entirely on how we proceed. Yet another major tax increase, with numerous specific tax proposals that will directly inhibit the forces that could otherwise lead to higher productivity growth and improved international competitiveness, will not advance the cause of prosperity in the United States.

Mr. BREWSTER. Thank you, Mr. Foster.
Mr. Lawrence.

STATEMENT OF ROBERT Z. LAWRENCE, PH.D., ALBERT L. WILLIAMS, PROFESSOR OF INTERNATIONAL TRADE AND INVESTMENT, JOHN F. KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY, ON BEHALF OF THE COUNCIL ON RESEARCH AND TECHNOLOGY (CORETECH)

Mr. LAWRENCE. Thank you, Mr. Chairman.

First, I would like to request that testimony written by Gary Hufbauer, of the Institute for International Economics, on the question that I am talking about, be introduced into the record.

It is a pleasure for me to appear here today on behalf of CORETECH, which is a coalition of firms and educational institutions who are concerned about promoting research and development. I think it is well recognized that research and development is critically important to our economy, and particularly, given our slow productivity record and our competitiveness problems.

I am, therefore, very heartened that the administration has endorsed a permanent research and development tax credit, and I think that they are to be applauded for this. I am also heartened by the general concern which they have shown for this set of problems.

It is well recognized that private markets work very well, but in some cases they fail to do things which are appropriate from a social standpoint, and the performance of research and development is one of those. Since private entrepreneurs cannot capture the full benefits of commercial R&D, they underinvest. And so it is quite appropriate, from a social policy standpoint, that the Government supplement the incentives which they have to perform this activity.

Moreover, recent research shows that, in fact, R&D spending is sensitive to incentives. James Heinz, of Harvard University, Branwan Hall, of Stanford University, have recently produced very interesting papers which find sensitivity of R&D to incentives.

What I am concerned about, however, is that, given this sensitivity to incentives, the current package, as I see it, is going to have a negative impact on the overall incentive to spend on R&D. In thinking about incentives, it is useful to divide up the effects on the costs of doing R&D and the effects on revenue or income of doing R&D, together the difference between the revenue, and the costs will determine the overall incentive.

Now, from the standpoint of the cost side of doing R&D, the proposal actually helps, by moving the 861 provisions from a 64-percent deferment allocation allowance to 100 percent. In fact, as estimated, that would raise revenues from the current situation or from the 64-percent level of about $100 to $150 million, so we get a plus.

But on the other side, the treatment of fees and royalties will have a very, very negative effect. One indication of the negative effect is that this is going to raise revenues, originally estimated at about $1.2 billion, currently apparently probably closer to $2 billion.

So what we see, when we view this program in context, is that, on balance, it gives those companies who engage in research and

development in the United States, it has a very negative impact on them, basically a hit of around about somewhere between $1 billion and perhaps to $1.8 billion. Contrast that, if you will, with the costs of the R&D tax credit, roughly $1 billion to $1.2 billion.

So what you see there is this package, in terms of its revenue effect, which is a rough indicator of its incentive effects, is actually going to have a negative impact. It is just as if we repealed the R&D tax credit, which I believe is the last thing we ought to be doing. We ought to be enhancing that credit.

Let me just state, on the question of runaway plans, which we heard so much discussion about today, if you actually look at the way the current Tax Code is structured, when it comes to the performance of research and development, we currently have an anti-runaway laboratory system. We are giving firms currently, because of the 861 provision, even though it is only at a 64-percent level, we are currently giving firms an incentive to perform R&D in this country. In addition, we have an R&D tax credit, and I think that is just as it should be, given the benefits to our economy from this activity.

But to move now in the other direction is something which I cannot believe is an intended consequence on the part of the administration. I don't think it is adequate enough to simply say that these incentive effects will be offset by making the R&D tax credit permanent. I think this particular provision ought not to be enacted. That is one option.

An alternative would be to supplement this with a much more generous research and development tax credit. That is what Gary Huffhauer proposed, when he sat back and thought about the whole picture of our tax treatment of foreign firms, at least U.S. firms who were based abroad.

So, in sum, I applaud the administration's concern with competitiveness, I applaud the broad structure of the—actually, I differ with the last witness on the broad thrust of the program, but I think this particular provision warrants reexamination.

Thank you very much, Mr. Chairman.

[The prepared statements of Messrs. Lawrence and Hufbauer follows:]

Written Statement of
Robert Z. Lawrence[1]
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On Behalf of the Council on Research on Technology (CORETECH)

Hearings On Administration's Revenue Proposals

Before the Committee on Ways and Means U.S. House of Representatives

April 1, 1993

The Tax Treatment of R&D in the President's Economic Program

Over the past several years we have completed a number of studies of the impact of tax incentives on R&D spending by U.S. companies. We have also testified on numerous occasions to the House Ways and Means Committee and to the Senate Budget Committee on technology policy. We have prepared this discussion at a time when technology policy and the tax treatment of R&D are under review.

The administration has given a clear commitment to policies that will enhance technological innovation. We welcome this. In particular, we applaud the administration's efforts to make permanent the research and experimentation (R&E) tax credit -- a step that we feel is long overdue.

At the same time, we are concerned that changes in the tax code proposed in the President's program would offset the benefits of a permanent R&E credit and actually leave U.S. companies with less incentive to perform R&D in the United States than they have had in recent years. These changes involve two elements; first, the 861-8 provision (under which U.S. companies with international operations are required to allocate a percentage of their R&D expenses to foreign-source income); and second, the tax treatment of foreign fees and royalties.

The 861-8 allocation rules as they were written in 1977 would mean that companies that have excess foreign tax credits (companies that perform the bulk of U.S. R&D) would, effectively, lose the deductibility of a large part of their U.S. R&D expenses. This would be a heavy tax penalty. Except for a brief period, however, this provision of the law has been subject to special rules that have meant that most R&D was not subject to the allocation rule. For example, recent Treasury regulations have stated that 64 percent of R&D expenses can be deducted directly against U.S. income and that only the remaining 36 percent is subject to allocation.

With respect to income from foreign fees and royalties, companies have been allowed to place these in the "general" basket of foreign source income. This has reduced the tax burden on companies with excess foreign tax credits.

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[1]The views expressed here are the author's own and do not reflect the views of Harvard University or the Brookings Institution. This testimony grows out of joint work with Martin Neil Baily of the University of Maryland and Brookings.

It is now proposed that the 861-8 allocation rules be abolished so that all R&D performed in the U.S. can be deducted against foreign-source income. But it is also proposed that income from royalties be placed in the passive basket for foreign-source income. These two proposed changes work in opposite directions. On the one hand, R&D spending in the U.S. would be made more attractive because of the full 861 exemption, on the other hand, R&D would become less attractive because of the increased taxation of the royalty income that it earns in foreign markets.

If the proposed changes were roughly equal in their effects, then they would not be a serious concern for technology policy. And it is our understanding that policymakers in the administration may have believed that was roughly the case. But in fact it is not. Shifting from a 64 percent rule for the 861-8 provision to full exemption would yield between $100-150 million as a tax saving for U.S. companies and an equivalent tax loss for the Treasury. This tax saving is calculated relative to the 64 percent rule that has been in effect over the past several years, but note that the 861-8 provision has almost never been fully in force since 1977.

The change in the tax treatment of foreign royalty income would cost U.S. companies $1.2 billion, according to the Treasury estimate, although this figure may turn out to be a substantial underestimate of the true impact of the proposed regulation. Thus the combined effect of the two provisions is to impose at least a $1 billion penalty on companies performing R&D in the U.S. This is an amount which is of a similar magnitude to the annual cost of the R&E tax credit. It would represent a significant disincentive to R&D in the U.S. offsetting, to some extent, the beneficial effects of the R&E credit.

We applaud President Clinton's efforts to reduce the Federal budget deficit and we believe that this can only be achieved through a combination of expenditure cuts and revenue increases. But we are concerned that raising revenue by penalizing R&D is a serious mistake and against President Clinton's intent. This administration has emphasized technology promotion, a stance that we strongly support. We recommend that any changes in the tax code be made in way that does not penalize R&D, ideally we would like to see additional incentives provided.

We are not alone in this view. In his study U.S. Taxation of International Income: Blueprint for Reform published by the Institute for International Economics, Gary Hufbauer, argues that "any change in tax policy should accomplish two things at the same time. First, it should end the bias against the domestic use of technology...and second, it should maintain or improve the level of tax incentives for the generation of technology in the United States."

Hufbauer does propose that royalty income be subject to taxation (in conjunction with the allocation of all headquarters expense against U.S. income). And perhaps Hufbauer's analysis has influenced the proposed tax changes that are now being considered. But Hufbauer's plan is for a package of tax changes. He proposes (a) transition rules to cushion the impact on firms heavily reliant on royalties, (b) negotiation of the elimination of withholding taxes applied by many countries to royalties payments and (c) an R&E tax credit that more than offsets the revenue gains from these changes. He estimates that in order to avoid reducing the incentive for R&D as a result of these changes it would be necessary to apply an R&E tax credit that is between 5 and 8 times as large as the current credit and would cost $7.6 billion in 1995 (see pages 138 and 231-234 of his study). He stresses that "No competitive benefit will come from picking and choosing those parts of the package that offer to raise still more revenue from the U.S. corporate sector" (page 135).

As we have noted in our earlier studies, economists have generally accepted that R&D is an activity that has a much higher social rate of return than its private rate. This means that too little R&D is performed in a market economy unless there are incentives for R&D that are provided by policy. But despite this, the R&E tax credit and other elements of the tax treatment of R&D have been controversial in the past because of claims that R&D spending does not respond to tax changes. We believe that the weight of the evidence should now lay that issue to rest. Professor James Hines of Harvard University and Professor

Bronwyn Hall of Berkeley have just completed independent studies showing strong evidence of the tax sensitivity of U.S. R&D spending. It seems clear that U.S. companies will increase or decrease the amount of R&D they perform in response to the incentives or disincentives that are provided by the U.S. tax code.

We would strongly urge the Administration to rethink its proposals to make sure that they do not reduce the incentives to perform R&D in the United States, and preferably that they increase those incentives. The decisions that are being made now about the tax treatment of R&D are important for U.S. productivity growth and competitiveness.

TESTIMONY OF GARY C. HUFBAUER

THE ADMINISTRATION'S INTERNATIONAL TAX PROPOSALS

In October 1992, the Institute for International Economics published a book that I authored together with Joanna van Rooij, titled U.S. Taxation of International Income: Blueprint for Reform. In that book, we laid out a comprehensive plan for reforming the existing hodgepodge of international tax rules. These rules are all but impossible to administer and often do a great deal of harm to U.S. firms that are trying to compete in global markets.

The main reason why U.S. international tax rules are in such bad shape is that, over the past thirty years, no Administration or Congress has comprehensively reconsidered outdated tax doctrines inherited from the 1950s -- even though that era of U.S. industrial supremacy has long since been replaced by a global battle for economic leadership. Instead of a back-to-basics review, most legislative effort in the international tax area has been devoted to efforts to "tighten" assorted provisions, in hopes of raising additional revenue.

In some ways, President Clinton's international tax proposals can be read as precursors to fundamental reform. For example, more attention will be given to the transfer prices at which foreign multinationals do business with their U.S. subsidiaries. The scope for "earnings stripping" will be narrowed. "Passive" foreign income earned by U.S. oil and gas extraction firms will be treated as "passive". While these individual proposals are not placed in a broader context, they are at least consistent with the far more extensive reform proposals outlined in our book. Unfortunately, that is not the end of the story. In some respects, the Administration's proposals are seemingly taken from the same hymn book that gave us such bad melodies in past years.

Like most Americans, I applaud President Clinton's efforts to reduce the federal deficit. To help achieve this goal, some additional taxes will have to come from international income flows. Our book pointed out areas -- not touched in the Administration's proposals -- where revenues could be raised, notably by insisting that the residence principle should apply to international flows of portfolio income. But we emphasized that additional U.S. taxes should not be raised in ways that would damage the ability of U.S. firms to compete in world markets. In particular, we stressed that higher U.S. taxes on technology income derived from abroad (i.e., royalties received from the foreign use of patents, copyrights, trademarks and trade secrets) should be fully offset by new tax incentives designed to maintain the overall level of U.S. research and development. Unfortunately these guideposts were ignored in key parts of the Administration's proposals.

The economic analysis underlying our prescription is simple. The United States benefits twice over when U.S. firms operate on a worldwide basis.

First, a U.S. manufacturing presence abroad acts as a powerful draw for U.S. exports. As my colleague Edward M. Graham has shown in paper that will soon be published,[1] the size of U.S. manufacturing investment in a foreign country positively and significantly increases U.S. manufactured exports to that country. Since U.S. export industries pay about 17% better wages than the U.S. average, any policy that helps exports in turn helps Americans find good jobs.

Second, a U.S. firm that has worldwide operations can far more easily spread its expensive overhead costs, including R&D outlays, and thereby lower its average costs. For high-tech firms, this is

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[1]Edward M. Graham, "Territorial Taxation, US Direct Investment, US Exports and US Headquarters Activity", Report prepared for Center for Strategic Tax Reform, March 1993.

especially important. To give an example, suppose a firm has annual R&D outlays of $100 million, and U.S. sales of $800 million. If this company can add $200 million of sales by producing abroad, then it can reduce its R&D costs from 12.5% of sales to 10%, a significant benefit in a competitive global environment.

In terms of enhancing the competitiveness of U.S. firms, the Administration's international tax proposals take one step forward and one step backward. Unfortunately, the forward step is modest, while the backward step is large.

The forward step, one strongly recommended in our book, is to amend Section 861 so that all outlays for R&D performed in the United States are allocated to U.S. source income. This is an improvement by comparison with the present regulation which apportions 64% of such R&D to a firm's U.S. income, and divides the rest between the firm's U.S. and foreign income. The proposed change will encourage not only U.S. firms but also foreign firms to perform R&D in the United States. Moreover, the amendment will settle an area of tax law that has been in flux since regulations under Section 861 were issued in 1977.

In estimating the revenue cost of this welcome step, however, the Treasury has followed technical procedures that result in an inappropriate estimate from the standpoint of economic impact. Instead of calculating the cost against a baseline of the current 64% "exclusive apportionment" rule, the cost of the proposed amendment is calculated against a baseline of the 1977 regulations. The 1977 regulations had a 30% "exclusive apportionment" rule (30% of R&D expense was apportioned to U.S. source income and the remaining 70% was divided between U.S. and foreign income). This use of an inappropriate 1977 baseline multiplies by a factor of three the apparent revenue cost of the proposed change, an increase from about $300 million dollars annually to about $900 million annually.

When this exaggerated revenue cost is lumped together with the revenue gain from the second step (described momentarily), the net revenue gain seems modest, $358 million in 1995 and $1,769 million over 5 years. The seemingly modest net gain from both steps taken together, coupled with the proposed extension of the incremental R&D tax credit, might lead some observers to conclude that the Administration's tax proposals are "R&D friendly". This would be an erroneous conclusion.

The second step, the backward step, is to put all royalty income in a separate "passive" basket for foreign tax credit purposes. With this change, the U.S. foreign tax credit will be limited to the foreign withholding taxes, typically imposed at a rate of about 10%. No "cross-crediting" will be allowed for foreign taxes imposed on corporate earnings, even though corporate tax rates abroad are sometimes in excess of 50%.

According to my estimates, with this change the additional U.S. tax on royalty income from abroad could easily reach $1.9 billion in 1995. The net result of this step, taken together with the amendment to Section 861, will be to increase U.S. taxation of income derived from R&D by at least $1.6 billion in 1995, and by at least $8.1 billion over five years. In making these net estimates, I have contrasted the proposed changes with current U.S. tax rules, not the rules in place in 1977 (the baseline for Treasury estimates of the revenue cost of amending Section 861).

In turn, higher taxation could reduce R&D outlays in the United States by as much as $3.0 billion annually by 1997 -- a significant cut in an industry R&D budget that will then be about $140 billion. Moreover, these changes clearly will not enhance U.S. strength in high technology. Instead of promoting U.S. competitiveness, these proposals, if enacted, will erode the United States as a place to undertake research and development. This

outcome is totally inconsistent with President Clinton's broader goal to "compete not retreat".

The fact that the Administration proposes to make the incremental R&D tax credit permanent does not alter my assessment of the international proposals. I welcome a permanent credit. But the incremental R&D credit has been in place for many years, and its extension cannot be heralded as a new incentive.

Our book advocated a 10% R&D tax credit on all R&D, not just incremental R&D. Only in conjunction with a new 10% credit would it be consistent with our recommendations to put royalty income in a separate basket for foreign tax credit purposes. These changes (and others) should all be seen as elements in a tightly linked reform package. As we said in our book (p. 135): "No competitive benefit will come from picking and choosing those parts of the package that offer to raise still more revenue from the U.S. corporate sector." As it stands, the Administration's proposal would act as a significant disincentive to U.S. technological strength.

Mr. BREWSTER. Thank you, Mr. Lawrence.

Mr. Foster, as a member who certainly supports cutting spending and have demonstrated that several times, I think you also know that the way our spending pattern is at the moment, that social security, Medicare and that part of the entitlements make up 35 percent of our spending, Medicaid makes up 15 percent of our spending, interest makes up 14 percent of our spending, defense is 20 percent, and currently discretionary domestic spending is 16 percent. If all of discretionary domestic spending is eliminated, every dollar spent on education, roads, agriculture, et cetera, we still have a deficit.

Does the Tax Foundation go on record as supporting further cuts in defense or cuts in entitlements such as social security?

Mr. FOSTER. The Tax Foundation is really not in a position to advocate where the cuts ought to take place. Clearly, the source of the spending problem right now is primarily in Medicare and Medicaid. It is even a narrower group than entitlements. It is in those two areas where the explosion in spending is occurring. Frankly, if you look at the budget numbers in the outyears, what we have right now is modest compared to what we face 3 or 4 years from now.

The problem is not in defense spending, because obviously that is coming down. International discretionary spending has been pretty flat. The nondefense, noninternational, or domestic discretionary spending exploded in the first couple of years after the 1990 budget deal, but this is now flattening out, as well. At least that is what the numbers are currently projected to be.

But the prcblem for the future is clearly in Medicare and Medicaid. But it would not be up to the Tax Foundation to suggest where the tax cuts should fall. We are looking at it from an economic perspective.

Mr. BREWSTER. The reason I asked the question is, you are aware, for Congress to ever address those, it is going to take a lot of support from a lot of people.

Mr. Farmer, you appeared to oppose all international revenue raisers and, in fact, recommended additional revenue losing modifications of current law. As the Ways and Means Committee seeks to discharge its obligation with respect to the budget resolution, where would you suggest we look to replace those revenues?

Mr. FARMER. That is a difficult question and I am not sure I am in the position to answer that. But I would respond by saying that most of the problems that I think we have in the international area are a result of the 1986 Act, and most of that was funded by reducing rates across the board, so I guess the U.S. Council generally feels that it is more appropriate to take the revenue and share it more, than trying to take it from the international provisions, especially when the provisions have the effect of making us less competitive, especially the royalty and the cutback on the deferral.

Mr. BREWSTER. Mr. McNeill, I am a pharmacist by profession and had an opportunity to go through Abbott Labs when I was a senior in college some years ago. I know your company has significant investments in Puerto Rico. If the President's proposal on 936 were to occur, how would your company respond?

Mr. McNEILL. Abbott Laboratories is a member firm of ECAT, Congressman.

I used to be a professor at the University of Puerto Rico, and I wrote a book about economic development in Puerto Rico, which was my doctoral dissertation, so I am particularly familiar with that commonwealth.

My guess is that if the President's proposal were enacted and a credit of 65 percent of the wage level were provided, that that in the end would not result in any additional Federal revenue. I think there are several reasons for that. If the moneys that are deposited in Fomento and other Puerto Rican banks, so-called section 936 earnings, were repatriated from Puerto Rico to the mainland or to some other place, the government of Puerto Rico would then be hard put to maintain the level of transfer payments to its citizens.

I further think that you would then see additional unemployment in Puerto Rico. If the Puerto Rican economy were not able to offer job opportunities, I think that there would be a substantially increased stream of emigration from Puerto Rico to the mainland, which, in and of itself, would result in additional Federal transfer payments.

But equally important, I think for large municipalities such as New York City or Hartford, CT, Boston, MA, Baltimore MD, or Washington, DC, that there would be an additional burden on those communities in respect to additional transfer payments that would be required to meet the societal requirements of those presumably unemployed persons who would emigrate from Puerto Rico to these and other U.S. cities.

In terms of the Federal Treasury, I would estimate that the commonwealth government would impose a transfer tax on funds coming back to the United States, so that the Federal Treasury would not necessarily receive as substantial amounts of revenue as may be anticipated.

I myself do not see the proposed change in section 936 as a revenue gainer for the Federal Government. I think for some American companies, including those in Puerto Rico that utilize the section 936 provision, I think that a lot of those companies would perhaps remove productive facilities from Puerto Rico. It does not follow, however, that those facilities would come back here. They might well go to other Caribbean nations or the Pacific rim or to Mexico or elsewhere.

So I really do not, Congressman, see this as a substantial means of reducing the Federal deficit.

Mr. BREWSTER. Mr. McNeill, I looked at Mr. Burnham's testimony, and he is CEO of Abbott Labs, and I assumed that you were Abbott Labs also.

Mr. McNEILL. I do understand the confusion since I represent Abbott Laboratories as well as 59 other large U.S. companies.

Mr. BREWSTER. Along with the question on 936, is there a middle ground anywhere between the way things are today and the President's proposal?

Mr. McNEILL. There is an obvious middle ground. I would not presume to suggest what it is, sir, without a lot of study.

Mr. BREWSTER. Thank you.

Mrs. Kennelly.

Mrs. KENNELLY. No questions.

Mr. BREWSTER. Gentlemen, if there are no other questions, it is certainly a pleasure to have you here today. Your testimony will be put in the record in its entirety. We have had a very good day of testimony from many different people on these panels, and we appreciate your efforts to be here.

Mr. MCNEILL. We thank you for your courtesies.

Mr. BREWSTER. The committee is adjourned.

[Whereupon, at 3:23 p.m., the hearings were adjourned.]

[Submissions for the record follow:]

ACME BOOT COMPANY, INC.
FACT SHEET
FRIDAY, APRIL 2, 1993

- In order to compete in the increasingly competitive and global retail industry, Acme Boot Company, like most footwear and apparel companies, has had to change its strategic direction by putting less emphasis on manufacturing and more emphasis on selling and marketing products from a variety of domestic and foreign sources.

- Acme Boot Company has not been a healthy company over the last five years with the average net earnings being negative for that period.

- Acme Boot Company did, however, increase production last year at its newest plant in El Paso, Texas, doubling employment. This plant now produces boots under the brand names Acme, Dingo and Dan Post. With additional capacity available in El Paso, Texas, Acme plans to expand its production there in 1993 and employ additional workers. This plant will absorb a substantial amount of the existing production in Clarksville. Acme also increased its employment and production in its Lucchese plant in 1992, also in El Paso, Texas.

- Acme will continue its domestic sourcing of boots from two factories in Tennessee and one in Virginia and plans additional increases in 1993. The Company has also sourced product from Brazil, Mexico and India for several years.

- The percentage of footwear assembled domestically by Acme was over 80% in 1992, and, in 1993, this percentage will stay about the same. This is in contrast to the domestic footwear industry where over 80% of the footwear sold at retail is imported.

- Acme announced in May of 1992 that it was giving serious consideration to closing its Clarksville plant. In September of 1992 Acme participated in good faith bargaining with Local 330 URW on the Clarksville plant. After good faith bargaining a decision to close Clarksville was finalized.

- In October of 1992 the Clarksville plant closure was announced. The first layoffs have occurred and the plant will be closed May 21, 1993.

- The Clarksville plant closure decision is final, and stands on its own without regard to production at any other facility.

- The 200 people currently employed in the Clarksville distribution center and the company's corporate headquarters will remain in Clarksville. The distribution center, which is being upgraded with new software programming to better service our customers in the 90's and beyond, is represented by the United Rubber Workers 330. The Union recently agreed to a one year extension to the current contract. The most senior workers in the Clarksville plant that want to work in the distribution center, will be employed based on personnel needs and the current collective bargaining agreement.

- Acme Boot Company is going beyond any legal or contractual requirements to help the approximately 450 displaced workers in Clarksville with job training and other employment opportunities.

- In December of 1992, the Union filed charges against Acme with the National Labor Relations Board. In January, the NLRB, after hearing and reviewing both parties' statements, dismissed the complaints. The Union filed an appeal in Washington to the dismissed complaints and the NLRB again in the last two weeks dismissed the appeal.

- The leased finishing facility planned in Toa Alta, Puerto Rico is not replacing production in Clarksville. The plant in Toa Alta will take boot uppers sourced globally and last them, bottom them and finish them.

- Instead of following the practice in the footwear industry to move production to a foreign country, Acme selected Puerto Rico because it is America, it allows us to have more control over the process, that there is a strong infrastructure for footwear assembly in the commonwealth already with companies like Dexter, Sperry, Timberland and Bass. They have well educated quality minded American workers available and like a number of states, offer start up incentives for building, training and employing American workers. Our overall unit costs will be less there than in Tennessee or Texas but more than if we were going to a foreign country. Additionally, local and federal tax incentives are offered to companies establishing assembly facilities in Puerto Rico. This plant should employ at least 150 American workers in twelve months.

- Acme Boot Company believes it is not in violation of any U.S. or Puerto Rico tax codes by taking advantage of business incentives offered by the Puerto Rican government or the federal government for this new leased facility. The Company believes it is in full compliance with all federal and local laws in terms of labor laws, work incentives and tax codes. And, we are operating today in P.R. without the benefit of 936 since we have not filed for that status. We feel that even if there is a change in 936 we still will be in Puerto Rico.

# # #

AMERICAN
BANKERS
ASSOCIATION

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20036

DIRECTOR, TAX AND ACCOUNTING
Henry Ruempler
202/663-5317

April 2, 1993

The Honorable Dan Rostenkowski
Chairman, Committee on Ways & Means
House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The American Bankers Association is pleased to submit its views on some of the corporate tax proposals contained in President Clinton's February 17, 1993 message. In particular, our comments are directed at the temporary incremental investment tax credit, the corporate tax rate increase and the targeted capital gains provisions. All of these proposals significantly affect the cost of capital in the business sector.

The American Bankers Association ("ABA") is the national trade and professional association for America's commercial banks. ABA members are located in all fifty states and the District of Columbia and include banks of all types and sizes -- money center, regional and community banks. Assets of ABA member banks represent approximately ninety percent of the industry total.

The banking industry's view on these provisions are driven not only by how they affect the banking industry, but more importantly how they affect the broad business sector in the United States. As lenders which provide financing to all business sectors, the health of the entire U.S. business community is critical to our business. In general, bank economists believe a broad-based investment tax credit can be beneficial to the business community, by lowering the cost of business capital. These economists, however, are concerned that the temporary incremental investment tax credit for large companies will not accomplish significant stimulus and may actually create a pause in capital spending immediately after the credit expires. Moreover, many bank lending officers and tax experts who have studied the proposal believe that it is too complicated to be useful for lease financing for bank customers. The recapture provisions appear to be punitive and would make pricing of leasing transactions very difficult. We believe that most banks would not find it prudent to gear up their leasing operations in response to the temporary investment tax credit.

In 1986, Congress acted to reduce corporate tax rates, as an offset to the broadened corporate tax base. In light of the problems noted above which we perceive with respect to the temporary incremental ITC proposal, we would urge that the Committee consider adhering to the philosophy reflected in the Tax Reform Act of 1986. For example, if the estimated revenue cost of the temporary investment tax will roughly equal to a 1% change in the corporate rate, we urge the Committee to consider rejecting the credit in favor of a 35% corporate tax rate, rather than the proposed 36% rate. This would provide a more efficient and uniform benefit with respect to the cost of business capital. An additional concern involves the effective date for the increase in the corporate tax rate. As proposed, the higher corporate rate would be effective for the entire calendar year 1993, even though the legislation probably won't be enacted into law until the third quarter of the year. The result would be that the impact of increased corporate tax rate (whether 1% or 2%) would be bunched up and reflected in third quarter earnings, rather than being spread uniformly throughout the year. We are concerned that published information that corporate earnings were down in the third quarter might be misunderstood, even if it was attributed solely to the change in the tax law. In the case of banking institutions, our published earnings are important not only to justify the confidence of our shareholders, but our depositors as well. This problem could be corrected if the Committee could move the effective date for any corporate tax change to the date of enactment.

Finally, we have an observation about the scope of the targeted capital gains proposal. The provision excludes from the definition of qualified small business many service sector industries, including banking. We do not understand why small banks were excluded from this provision. In the Federal Deposit Insurance Corporation Improvement Act of 1991, Congress acted to raise the capital requirements for commercial banks as the critical factor in ensuring the health of the Nation's financial system. Excluding banks from the 50% exclusion for capital gains for stock held five years....and possibly other tax provisions in the future....will have the effect of raising the cost of capital for small banks relative to other businesses which do qualify for the new tax benefits. We recommend the Committee explore why the tax proposal would run counter to the Congressional policy on bank capital expressed in FDICIA.

ABA is eager to work with the Committee as it debates tax legislation in the coming weeks.

Sincerely,

Henry Ruempler

Identical letter to Chairman Moynihan

cc: Leslie Samuels, Treasury Department
Frank Newman, Treasury Department

AMERICAN BOILER MANUFACTURERS ASSOCIATION
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TESTIMONY (TO BE SUBMITTED FOR THE RECORD) OF THE AMERICAN BOILER MANUFACTURERS ASSOCIATION

**COMMITTEE ON WAYS AND MEANS
HEARING ON
CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION**

Thank you, Mr. Chairman, for allowing the American Boiler Manufacturers (ABMA) to present their views on President Clinton's proposals for public investment and deficit reduction.

The American Boiler Manufacturers Association, founded in 1888, is a voluntary nonprofit corporation with headquarters in Arlington, Virginia. The only national trade association representing commercial, industrial and utility boiler manufacturers, as well as fuel burning system manufacturers, whose mission is to promote the common business interests of the industry; to improve its services to the public; to be proactive with government in matters affecting our industry; and to promote the safe, economical and environmentally-friendly use of products and services of its members.

We would like to focus on the proposed BTU (British thermal unit) energy tax because of its adverse impact on industrial production, competitiveness, business investment and job creation.

While the ABMA supports the goal of deficit reduction, the BTU tax will result directly in an additional major tax on manufacturers by raising the cost of industrial production. Energy is a principal component of the industrial production process and more than one-third of the proposed BTU tax will fall on industrial production processes of manufacturers. The BTU tax will increase the cost of energy used by American manufacturers in making their products.

The BTU tax will thus hurt U.S. competitiveness by making U.S. production more expensive than foreign production, raising the cost of American goods in both home and overseas markets.

The ill-effects of the proposed BTU tax on American manufacturing goods can not be overstated given the fact that manufactured goods account for more than 80 percent of U.S. merchandise exports. Manufacturing exports have in recent years accounted for 30 to 60 percent of U.S. economic growth.

It has been estimated that, when fully implemented, the BTU tax will cost 600,000 jobs and reduce the Gross Domestic Product (GDP) by nearly $40 billion annually. The price increases resulting from the BTU tax will increase federal spending in programs that are subject to automatic indexation.

The result:

> The net amount of deficit reduction from the proposed BTU tax is only going to be around $10 billion. Thus, the BTU tax would impose considerable damage to the economy while being quite inefficient as a deficit reduction device.

The ABMA would urge more spending cuts as a way to reduce the deficit. Imposing a BTU energy tax appears inconsistent with the President's stated goals of increasing investment, creating jobs and expanding economic growth. Further, singling out energy-intensive industries to bear a disproportionate burden of deficit reduction is harmful to economic growth. In recent years these same industries have been singled out to bear escalating costs associated with compliance with federal government regulations. Moreover, regional disparities combined with problems in administering this energy tax would further impose serious impediments to implementation.

ABMA believes that the proposed BTU-based energy tax is a tax on industrial production rather than a consumption tax. Therefore, ABMA views the proposed BTU-based energy tax as an extremely poor choice to reduce the deficit.

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STATEMENT OF THE
AMERICAN COLLEGE OF RHEUMATOLOGY
TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
FOR THE RECORD OF THE HEARING
MARCH 10, 1993

RE: PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

The American College of Rheumatology (ACR/the College) is pleased to submit a statement to the House Committee on Ways and Means for the record of the March 10, 1993 hearing on President Clinton's proposals for public investment and deficit reduction. The College is committed to efforts to stimulate the economy and reduce the federal budget deficit.

The ACR is the professional organization of rheumatologists. It includes practicing physicians and research scientists who are dedicated to preventing disability, healing and eventually curing more than 100 types of arthritis and related disabling and sometimes fatal disorders of the joints, muscles, and bones.

Our comments will focus on three of the President's proposals which affect the Medicare Part B program. Specifically, the plans to (1) phase in a resource-based practice expense index for the Medicare Physician Fee Schedule (MFS); (2) reduce the Medicare conversion factor by 2 percentage points for all services except primary care; and (3) reduce the default formula for the Medicare Volume Performance Standards (MVPSs) and the conversion factor updates.

Resource-Based Practice Expenses (RBPEs)

The ACR has been a strong supporter of basing the practice expense component of the MFS on resources. We have always supported this in concept because we believe that basing payments on resources is the most equitable way to reimburse physicians.

The current historical charged based methodology for assigning practice expense relative value units to physician services continues to create inequities for primary care and other evaluation and management oriented physicians. Only 54 percent of the Medicare Physician Fee Schedule (the work component) is resource based. Practice expense (41 percent) and malpractice expense (5 percent) continue to be based on distorted historical charges. The effort to reform Medicare physician payment is only half finished.

While we therefore support efforts to move to a resource based practice expense index as quickly as possible, we are very concerned about the President's proposal in this area.

The President's Proposal on RBPE: Phase In and Reductions -- The President's plan starts off with a good idea. It would phase in resource-based practice expenses beginning in 1997; although the actual method would need to be developed and more data collected before that time. This element of the President's proposal has been recommended to Congress by the Physician Payment Review Commission (PPRC) and we believe it is a step in the right direction. The President's plan, also however, calls for reductions in the current practice expense relative value units (RVUs) for certain services in 1994, 1995, and 1996, prior to the phase in of resource-based practice expenses.

Specifically, the President's proposal would "reduce the practice component...when it exceeds the value of the work component[1]." The proposal "would reduce practice expenses in relation to the

[1] A Vision of Change for America, Executive Office of the President, Office of Management and Budget (February 17, 1993), pages 97-98.

relative value work units by one-half of the difference between practice expense and physician work relative value units[2]."

When the practice expense value exceeds the work value for a particular service, we understand that the Administration is planning to reduce the practice expense RVU by 25 percent of the difference between the PE and work values in 1994; 50 percent of the original difference in 1995, and 75 percent of the original difference in 1996. This is the same as reducing the PE values by 25 percent of the original difference between work and PE each year for 1994, 1995, and 1996. The President's plan also sets a floor of 110 percent of the work amount. That is, the practice expense value cannot be reduced below 110 percent of the work RVU under the President's proposal. The savings from this plan is estimated at a little over $2 billion over a four year period.

ACR's Concerns -- If the President's plan on resource based practice expenses is implemented as written, the College is very concerned that there won't be enough monies left in 1997 and beyond for sufficient redistribution to services with undervalued practice expenses including primary care, or that redistribution will never take place if future further cuts are sought at that time.

The College and many others have always supported the Resource-Based Relative Value Scale (RBRVS) which was used for the MFS because philosophically we thought it was a much more equitable way to pay physicians than via historical charges. Physicians supported this change because they understood that funds would be redistributed from overvalued surgical procedures to undervalued evaluation and management (EM) services. While this redistribution has occurred through the work component of the fee schedule, EM services and particularly primary care remain undervalued because of the historical charge based system for practice expenses.

Rheumatologists experience significantly higher practice costs as a percentage of income than most physicians because they are primarily office based, see fewer patients in day while providing lengthier visits, and for the most part cannot rely on better paid invasive surgical procedures or diagnostic testing to generate additional income to cover their overhead costs. According to Dr. Hsiao, the author of the RBRVS, it was reported that practice expenses for rheumatologists were 54 percent of their income -- the highest percentage of any other medical specialty studied.[3]

While we would like to see resource based practice expenses implemented in a budget neutral manner, we understand that medicine must do its part to contribute to reducing the federal budget deficit.

ACR's Suggested Alternative for Deficit Reduction --

Instead of only reducing the practice expense (PE) relative value units (RVUs) for services with higher PEs than physician work values (with a floor of 110 percent of the work amount) -- reduce PE values faster and deeper for overvalued services using the same or a similar method and at the same time increase PE values for undervalued evaluation and management services, particularly office visits; allowing the same level of savings as the President's current plan. This would clearly show Congress' commitment to encouraging primary care and would have the support of the primary care community.

Specifically, it could be done by:

1. **accelerating the transition.** For example, instead of reducing the practice expense RVUs for overvalued procedures by 25 percent each year, the RVUs could be reduced by 33 percent each year. Or, one could front load the reductions by taking 50 percent the first year and a little less each additional year (front loading would also probably save more money in the long-run, due to compounding).

2. **lowering the floor.** The current floor of 110 percent of the work RVU -- the maximum amount that the practice expense RVU could be reduced under the President's plan -- could be lowered further to 100 percent or 95 percent of the work value, for example.

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[2] ibid.

[3] "Relative Cost Differences Among Physicians' Specialty Practices," by Becker, Dunn, and Hsiao, JAMA, October 28, 1988, page 2400.

3. **applying <u>all</u> the additional saving that would result from accelerating the transition and lowering the floor to increasing practice expense RVUs for office visits and other evaluation and management services.**

4. To make this a more acceptable proposal to the medical profession, Congress may want to consider asking the Physician Payment Review Commission to identify and publish a list of services that current available evidence suggests are overvalued and undervalued as an alternative to arbitrarily applying reductions to any service when the practice expense RVU exceeds the work RVU.

5. Also, if the President's proposed method is pursued, Congress may also want to consider asking HCFA to publish the list of services that would be affected and what the reductions (for overvalued services) and increases (for EM services, especially office visits) would look like when you set the floor or accelerate the transition differently each year from the proposed method. We have not been able to run these numbers ourselves.

We believe our suggested alternative proposal is a fair way to achieve the same amount of savings as the President's plan and at the same time show Congress' commitment to improving payments for primary care services, thus encouraging medical students and residents to enter into primary care.

<u>**Full Medicare Fee Schedule Increase for Primary Care Services**</u>

The College fully supports the Administration's plan to exempt primary care from the reductions proposed for all other physician services. The President's proposal would reduce the Medicare conversion factor by two percent for all services except primary care (which in the past has been defined in the Medicare statute as office, nursing home, and home visits). If these reductions are taken at the same time the Medicare update is provided based on the current MVPSs (which we understand is the Administration's intent), this proposal would in effect provide primary care with a full conversion factor update while reducing the amount of the update for all other services.

This would represent the first time in three years that primary care has received an update equal to inflation. By contrast, the 1993 update for primary care services was only 0.8 percent, compared to 3.1 percent for surgery -- the exact opposite of what should have been done to avert a crisis in primary care.

The President's plan appears to recognize that if cuts in Medicare are required, they should be targeted toward higher-paid services and the specialties that provide them rather than toward primary care. As objections are raised by some to other Medicare cuts, the primary care update could be at risk of being reduced. We ask you to oppose such measures to safeguard primary care.

<u>**Reduction in the Defaults for the Medicare Volume Performance Standards and Updates**</u>

The purpose of the President's proposal in this area is to reduce the amount of increases in physician fees in future years. The plan would reduce the Medicare Volume Performance Standard (MVPS) default formula and the default update for Medicare payments to physicians. **Unless a special provision is provided for primary care, this proposal would inadvertently negatively impact on primary care services.**

Rather than lowering the default MVPSs for both surgery and nonsurgery, the College recommends that a separate and higher MVPS be provided for primary care and other evaluation and management services, even if that requires a greater reduction in the MVPS for all other services to maintain the intended savings. This recommendation is for the default alone, as the College would prefer the Congress to act each year with respect to a primary care update; and that the conversion factor update for all evaluation and management services be determined outside the MVPS framework. This preferred approach has the support of the Physician Payment Review Commission.

Summary

The American College of Rheumatology:

1. supports the concept of phasing in a resource-based practice cost methodology for the Medicare Fee Schedule, but believes that the practice expense relative value units (RVUs) for visit services that are now too low should be increased, rather than just lowering the overpriced practice expense RVUs for procedures. The College has offered an alternative proposal (detailed above) which could achieve the same level of savings as the President's plan, while at the same providing an incentive to primary care.

2. supports the Administration's proposal to provide the full Medicare Fee Schedule increase (equal to inflation) to primary care services. This primary care update should not be reduced to achieve budget savings elsewhere. Efforts to reduce the deficit should be directed at higher-paid services and the specialties that provide them.

3. recommends that a separate and higher Medicare Volume Performance Standard (MVPS) be given to all evaluation and management services including primary care under the default formula even if that requires a greater reduction in the MVPS for all other services to maintain the intended savings. Instead of allowing the default to kick-in, the College would prefer that Congress act each year to set the primary care update and that the amount be determined outside the MVPS framework consistent with health policy goals of providing incentives to primary care.

The American College of Rheumatology is pleased to share our views with this Committee on the President's Medicare budget proposals. We believe that the Congress and the Administration want to support and encourage primary care even in this age of budget deficit reduction. Our recommendations would do just that.

acr/fullw/bjn

Testimony on behalf of
THE AMERICAN HORSE COUNCIL
on the
ADMINISTRATION'S TAX PROPOSALS
Submitted to the
Committee on Ways & Means
U.S. House of Representatives

March 31, 1993

INTRODUCTION

The American Horse Council (AHC) appreciates the opportunity to submit this testimony on President Clinton's economic proposals to stimulate the economy and reduce the deficit. The AHC is the national trade association for the horse industry in the U.S. and includes 191 equine associations, representing over 1 million individual horsemen and women and all breeds and types of equine activities.

The horse industry has been adversely impacted by several factors in the last eight years, including the downturn in the economy world-wide, changes made in the Tax Reform Act of 1986 and the expansion of other forms of gaming. Many racetracks and breeding farms have closed and many continue to struggle economically. Tens of thousands of jobs have been lost at racetracks, shows and breeding centers around the country. Hundreds of breeding farms, many a source of pride for their entire state, have been lost and along with them the beautiful open space that they provided.

Some of these losses can be reversed by changing the Internal Revenue Code to help the industry revive itself and produce more jobs, more revenue to the federal, state and local governments and a better balance of payments.

The President's economic plan gives Congress the opportunity to assist the industry and all it supports. We ask for that assistance and pledge that it will be repaid several times over in the form of more jobs, more farms and open space and more revenue to the federal, state and local governments.

President Clinton's economic plan proposes tax changes that could help the horse industry, provided we are included. The horse industry is not seeking special treatment, only fairness by including us in any provisions, such as the capital gains exclusion, investment tax credit and passive loss relief, that are intended to stimulate investment and produce jobs in other industries. There are also proposals that we oppose, such as the reduction of the deduction for business meals and entertainment, the denial of the deduction for club dues and the elimination of the deduction for lobbying expenses, because we feel they will chill any stimulus to jobs and the recovery.

U.S. HORSE INDUSTRY

The U.S. horse industry is a very diverse $15.2 billion industry that employs and supports hundreds of thousands of workers. Horse owners and breeders spend $13 billion in annual investment and maintenance costs. $200 million worth of horses are exported each year, far more than are imported. Horse farms and training facilities provide green space, often in areas that are being threatened by encroaching urban growth.

Parimutuel horse racing is legal in 43 states and involves the racing of Thoroughbreds, Standardbreds, Quarter Horses, Arabians, Appaloosas and Paints. Off-track and inter-track wagering is legal in 41 states. There are over 200 racetracks in the U.S. In 1990, over 79 million people attended the races, generating over $624 million in direct revenue to states from parimutuel taxes, track licenses, occupational licenses, admission taxes and

miscellaneous fees.

Another 40 million people view equine sports each year at horse shows and rodeos. There are 7,000 sanctioned horse shows a year with thousands of local, unsanctioned additional shows. These shows contribute $223 million annually to our economy with rodeos contributing over $100 million. 27 million people over twelve ride each year, more than half on a regular basis.

On the state level, California's horse industry generates the most dollars with a total GNP of $2 billion annually, followed by New York's $1.3 billion and Texas' $1 billion. Many other states have very substantial breeding, racing and showing industries.

The equine industry is very labor-intensive. Machines cannot be used to breed horses, train horses, feed horses and properly care for and exercise horses. Hundreds of thousands of individuals breed, own, train, use and care for horses. These people, who work full-time in the horse industry, include owners, trainers, grooms, jockeys, drivers and riders, veterinarians, instructors, van operators, racetrack employees and the countless others who do not work directly with the horse but whose livelihood depends on it. Many of these jobs involve unskilled or semi-skilled workers, who might be unemployable outside the horse industry.

What supports the horse industry, including the job base, the breeding farms and the revenue stream in the form of taxes to government, is the investment in the horses themselves. The horse industry relies on "outside" investments to operate, just as other businesses do. Without owners willing to buy, breed, race and show horses, the hundreds of thousands who are supported by the industry suffer. Without such investment, jobs and revenue are lost. All of this has been put at risk because of the downturn in the economy and changes in the tax laws that have occurred since the mid-1980s.

EFFECTS OF THE ECONOMIC DOWNTURN IN THE INDUSTRY

The horse industry has been hurt by several events in the last few years. The industry, like others, realized substantial growth in late 1970s and early 1980s but peaked in the mid-1980s. Eight years later the economic climate has changed dramatically and so has the horse industry.

In the late 1970s to mid-1980s, the horse industry prospered and expanded. Capital was available and was being invested in the horse business. But then the economy took a bad turn, not only in the U.S. but throughout the world. Foreign owners cut back on their purchases of U.S. bloodstock and the Tax Reform Act of 1986 changed the rules on investing. The reduction of the tax rates, the elimination of the capital gains exclusion and the addition of the passive loss rules impacted substantially on the desirability of investing in what might be called riskier investments, including real estate, oil and gas programs, new, small businesses, and the horse industry. The changes made it economically wiser to put capital in safer investments, such as certificates of deposit or the stock market, rather than in activities, like the horse business which produce jobs and revenue to the states.

Demand for horses declined but the industry already had a supply of horses in production. It takes three years to get a foal from conception to the two-year-old sales. Thus, the demand fell quickly, but the supply did not. Many owners and breeders who had purchased horses or bred them at pre-1986 prices sold them at post-1986 prices for substantial losses. People who had gotten into the business then, and even some who had been in for some time, got out. Others have stayed away.

This affected the entire industry, because it relies on the owners, many of whom cannot be involved full-time, and their investments to remain viable and expand. The breeding farms, stallion managers, feed suppliers, veterinarians, van operators, farriers, trainers, jockeys, grooms, stable hands, race tracks and their employees and suppliers, all rely on the horse owner and breeder. And when there are fewer owners the entire industry suffers.

Since the mid-1980s, the number of horses bred and registered has decreased for all breeds, as the attached chart shows. The number of Thoroughbreds registered has declined 25%, Standardbreds 29%, Arabians 57%, Morgan Horses 37%, Quarter Horses 40% and Saddlebreds 31%. The affect of this decline on the industry has been dramatic.

For the eighth time in the last nine years total revenue from public auction of Thoroughbred horses declined. There has been a 50% decline in revenue since the 1983 peak, when 21,500 horses were sold for $682.7 million. In 1992, 16,118 Thoroughbreds were sold, the lowest number since 1979, for $332.4 million. The average sale price was $20,585, the third consecutive years of decline and the lowest since 1979. Obviously, fewer people are willing to invest in horses. Figures from the Horsemen's Benevolent Protective Association (HBPA), the association of Thoroughbred owners and trainers, also reflect this. The number of individuals registered with the HBPA fell to 32,561 in 1992, a decline of 4.1% from 1991 and 7% since 1985.

This has lead to fundamental changes in the industry, to losses in jobs and less revenue to the states and the industry. Horse trainers who once had twenty horses in their barn and grooms necessary to care for them now have three and four horses and fewer workers. Many have had to take part-time jobs outside the industry. Racetrack veterinarians, who once worked exclusively on the track, are now making visits to farms to care for horses and make ends meet.

A brief look at the horse show circuit illustrates the effect of this loss of owners and reduction in the breeding of horses. A nationwide research study by the American Saddlebred Horse Association found that there are fewer small horse shows in the U.S. than there were ten years ago. The number of entries at horse shows has decreased. As mentioned, there are 7,000 sanctioned shows in the U.S. These shows, particularly the larger ones throughout the U.S., provide a viable living for thousands and thousands of ordinary, middle-class taxpayers who work full-time behind the scenes in a sport sustained by those able to pay the bills. Farriers and grooms are needed to take care of the horses; veterinarians, riders and trainers must keep them healthy, in good condition and competitive; managers, organizers, ring crews, advertising, feed and supporting services are needed for the shows to go on. And the local area reaps the benefits of the money that the show brings into the local economy, approximately $223 million per year. All of this is built on the horse owner and breeder who invests in the horse itself.

This may be brought into even clearer focus in racing, where several race tracks have closed and others continue to struggle economically. Those that have closed include Longacres in Washington state, Jefferson Downs in Louisiana, Roosevelt Raceway in New York, and Canterbury Downs in Minnesota. Garden State Park in New Jersey will cease operations on May 29 and Philadelphia Park may close. If this happens Philadelphia, the fifth largest population center in the U.S., will be without Thoroughbred racing for the first time since World War II. When these tracks closed, jobs were lost and revenue to the state and local governments stopped.

Those racetracks that continue to operate will experience a significant shortage of race horses this year and will have difficulty in filling races. Some tracks already have. Currently in New York, harness tracks are suffering from an acute shortage of horses to fill their regularly scheduled racing programs. Recently, Yonkers Racetrack was forced to cancel several races because of the shortage of horses. When races are cancelled, the lost wagering opportunities result in lost revenue to the tracks, the horse owners, the trainers, drivers and jockeys, and the state and local government.

This decline in the number of available horses has affected jobs and employment in the industry. It has affected revenue to the federal and state government. A review of the registered Thoroughbred and Standardbred foal crops over the last ten years illustrates the severity of the problem in racing:

	Thoroughbred	Standardbred
1983 foal crop	47,237	20,298
1984 foal crop	49,247	19,795
1985 foal crop	50,432	18,384
1986 foal crop	51,296	17,637
1987 foal crop	50,917	17,579
1988 foal crop	49,220	17,393
1989 foal crop	48,235	16,896
1990 foal crop	44,039	16,576
1991 foal crop	42,000	13,671
1992 foal crop (estimated)	38,500	13,029
1993 foal crop (estimated)	36,000	- - -

The size of the Thoroughbred foal crop has declined for seven consecutive years and the Standardbred crop for eight with the sharpest declines coming in 1991. This has long-term implications for racing and the industry it supports.

It takes three years for a racehorse to get to the track; in other words, the foals of 1990 are the three-year olds of today. Few horses race past the age of five. Although some tracks have felt the pinch, the real decline and scarcity of race-horses, and all that it will bring with it, will be felt dramatically at our nation's race tracks this year.

By 1995 racing as we know it may not be able to exist. The large foal crops of 1987 through 1989, last year's 3-, 4- and 5-year-olds are beginning to retire. With the sharp decline in the Thoroughbred foal crops of 1990 and 1991, there is a corresponding decline in the number of this year's 2-year-olds and 3-year olds, and next year's 3- and 4-year olds, etc. By 1995 the number of 2-, 3-, and 4-year-olds will fall to 116,500 and even if the 1994 foal crop remains at 36,000, and this is unlikely, the total number of registered Thoroughbreds between two to four and possibly racing in 1996 will be 110,500.

While the number of foals declines, the number of available races is staying approximately the same. Thus, the supply of racehorses in 1995 and thereafter will not be able to fill the races run. It is anticipated that the number of starters per race will decline from the average of nine available from 1984 through 1988 to seven. This decline in the number of horses available for racing will have a profound effect on the industry because racetracks will have two choices: (1) either cut back on the number of races or on the days of racing; or (2) run races with fewer horses. Either alternative will exacerbate the industry's economic problems and result in less betting, less revenue to the states and a loss of more jobs.

This decline can be explained as follows. Every time a dollar is wagered at a racetrack a percentage is taken out of the betting pool. This "takeout" provides the revenue to the states,

the income to the track, and the purses for the owners of the horses, the trainers, the jockeys and the drivers. The larger the amount bet, the larger the amount that is earned by the state, the track and the horsemen racing there. If this betting pool goes down it affects the entire industry because it reduces state taxes and income to the track and owners.

The decline in the number of horses available for racing will affect the betting pools. If tracks reduce the number of races or the days of racing, as some have, obviously less will be bet. If they simply race with fewer horses in smaller fields less will also be bet. Bettors dislike small fields because they offer less betting opportunities and smaller payoffs. The industry fears it may lose some of its best patrons if fields are reduced.

Thus, either alternative will result in smaller handles and less revenue to the states and the racing industry. This will exacerbate the current situation.

The decline in the number of horses and the industry in general is shown in other ways. A 1991 census in Michigan showed that there were 130,000 horses in the state, down from 160,000 in 1984. The equine industry in Michigan, which is primarily made up of small farms in suburban areas, pumped $256 million into the states economy in 1990 and income of $122 million. This is at risk.

In Maryland, where the horse industry is estimated to be a $1 billion industry, employing 20,000, many farms have closed. Windfields Farm, in Chesapeake City, home of Northern Dancer, the greatest sire of all time, closed in 1988. Sagamore Farm, once one of the finest in the state and home of Native Dancer, closed last Summer. In 1986, 4,000 mares were bred to Maryland stallions. In 1989, only 3,000 mares visited Maryland. Last year, the number was close to 2,000. Maryland breeding farms and farms elsewhere are an endangered species.

What has happened in Maryland has also happened in Kentucky, California, New York, Oklahoma and other states that have large and important breeding and training centers. It has impacted on the economies of these states.

SPECIFIC COMMENTS ON ECONOMIC PLAN

Several of the President's specific plans to stimulate investment and generate jobs do not apply to the horse industry. We believe that we have explained how hard the economic downturn and tax changes have hit the industry. Leaving the industry out of the economic stimulus proposals not only continues to favor other forms of investment over us, for no explainable reason, but also perpetuates the untenable position that the horse industry is not a serious business, not a large industry, and not one that produces jobs and revenue for the federal government and the state governments, entertainment for millions and a livelihood for hundreds of thousands.

We have the following specific comments on the President's proposal.

Change Passive Loss Requirements. The President's proposal does not change the passive loss limitations for horse owners and breeders. It does, however, provide for a special rule regarding passive losses and real estate. We do not oppose this relief, but suggest that limited relief also be afforded the horse industry, which has been hurt by the passive loss rules.

The horse industry is unique with respect to the material participation requirements. It is difficult for many owners to breed, train, ride, drive or show their horses because of the

expertise and physical ability that is required. It is a specialized and dangerous activity requiring experienced, trained professionals. The owner of a broodmare who boards the mare at another's farm may find it difficult to satisfy the minimum hourly requirement during the eleven month gestation period of a foal. The passive loss rules, therefore, are often viewed as difficult for many to satisfy.

Our position is that the passive loss rules enacted in 1986 should be repealed. We believe that they have done far more economic harm than good by stifling investment in some activities, such as the horse business. Nonetheless, absent a repeal we suggest two alternative approaches for relief that would encourage investment in the industry. The first would provide that passive losses from an equine activity would not be limited in computing an individual's regular tax liability, unless the losses came from an investment in a limited partnership. Instead passive losses which are not from a limited partnership would be restricted under present law rules in determining an individual's alternative minimum tax.

The second approach would modify the passive loss requirements to make it less difficult for an individual who owns and breeds horses to be an active participant. Specifically, in determining whether an individual is an active participant, our proposal would allow an individual to count all management time, even if others spent more or are paid for management services, and eliminate any specific minimum number of hours required. This could be limited to businesses engaged in breeding or using livestock for sporting purposes, provided the business is closely held with at least 80% owned by five or fewer individuals.

Include Equine Businesses in Capital Gains Exclusion. The President has proposed a lower capital gains rate for investments in small businesses, which are corporations with less than $25 million in capitalization. If stock in these small corporations is held five years, upon sale a taxpayer may exclude 50% of any gain and pay tax on the remaining 50%. The reasons for the change offered in the President's plan are that "small businesses are important to economic growth and job creation in this country, and contribute to America's edge in international competition."

The AHC suggests that the horse industry is ideally suited to accomplish the goals of this change. It is made up of hundreds of thousands of small businesses, is labor intensive and already has a favorable balance of payments and edge in international competition. Unfortunately, most horse businesses cannot qualify for the exclusion because they are not conducted in corporate form. More to the point, however, under the proposal, farming businesses are specifically excluded from this special capital gain treatment. Therefore, horse breeding operations, even if conducted through a corporation, could not qualify.

The AHC suggests that this special capital gains treatment be extended to include investments in the horse industry. It will result in additional employment and revenue to the states.

Include Horses in New Investment Tax Credit. Under current law there is no investment tax credit for tangible property. The President's proposal calls for a tax credit for small and large businesses. It would provide businesses with revenue over $5 million with a 7% investment tax credit for two years and smaller businesses with a 7% credit for two years and 5% thereafter.

The proposal states that property eligible for the credit "would be defined in the same manner as under the regular investment tax credit prior to its repeal, except that used property would not be eligible." Prior to 1986, the tax credit

was not available for the purchase of horses, but was available for other tangible property used in the horse business. Congress did not make the credit available to horses prior to 1986 because it did not see the need for an incentive to invest in horses.

As the earlier portion of our testimony sets out there is ample need today. The horse industry, particularly the racing industry which supports much of the job base in our industry, is in dire need of just such a stimulus. It would be grossly unfair to grant it to other industries while denying it to horses because of antiquated prejudices and unfounded beliefs. If racing declines further, so will employment and the revenue that it provides to the federal, state and local governments. The AHC supports the tax credit and requests that horses be included in its benefits.

Don't Reduce Deduction to 50% for Business Meals and Entertainment. Presently, 80% of the cost of business meals and entertainment is deductible provided it is an ordinary and necessary business expense. Meals and entertainment expenses include food, beverages, tickets for sporting events and similar activities. The President's proposal would reduce the deductible portion of otherwise allowable business meals and entertainment from 80% to 50% beginning in 1994.

This reduction in the meals and entertainment deduction from 80% to 50% will adversely impact anyone in the horse business who attends events or entertains at events and treats the cost as a deductible business expense. It will also affect the race tracks, horse shows and other events at which such money is spent.

Horse owners, trainers, veterinarians and others purchase tickets to race tracks, horse shows or other similar events in order to introduce new clients to the sport and entertain existing clients. This is a legitimate form of promoting the horse business, similar to advertising in other businesses. It is unfair and counterproductive to the President's purpose to single out one of the few important ways for the horse industry to promote itself.

More importantly, many of these individuals attend the races or horse shows in order to watch their horses run, look at other horses to purchase or just be informed and must purchase tickets in order to do so. Presently, 80% of the costs of these activities are deductible. The proposal would reduce the deductible portion to 50%. Reducing the business deduction for something that is so obviously an ordinary and necessary business expense is unfair. The AHC opposes this change.

Retain Deduction for Club Dues. The President's proposal would also eliminate any deduction for "club dues" beginning in 1994. The prohibition would apply to all types of clubs, including business, social, athletic, luncheon and sporting clubs.

This could affect the deductibility of dues paid by horse owners and breeders for "clubs" at tracks, such as "turf clubs," and at horse shows and similar events. To the extent that people use such clubs less this would adversely affect the events themselves and the employment and revenue they produce. The AHC opposes this change.

Retain Deduction for Lobbying Expenses. Under current law, expenses incurred for lobbying Congress or state legislatures are deductible as business expenses. This includes amounts incurred for direct communications with legislators, for communications through a trade association and for membership dues in an organization that lobbies.

Under the President's proposal businesses would no longer be

allowed to deduct lobbying expenses, including costs to communicate with the executive branch as well as the legislative branch. No deduction would be allowed for the part of membership dues that is used for lobbying and trade associations would be required to report to their members the portion of their dues used for lobbying activities.

This will affect all individuals and organizations that represent members before government, or belong to organizations, like the AHC and many of its member organizations, that do. The change includes state or local organizations that lobby state legislatures. Lobbying elected representatives is an important right of people involved in an activity. The costs of such activities have correctly been considered an ordinary and necessary business expense. The proposal will deny the deduction of these costs, including dues paid to organizations that lobby. This is unfair and counterproductive to the purpose of government which is to hear from constituents. Membership organizations that lobby will have to keep additional records to be able to advise members of what portion of their dues are not deductible. This is an unnecessary and burdensome change.

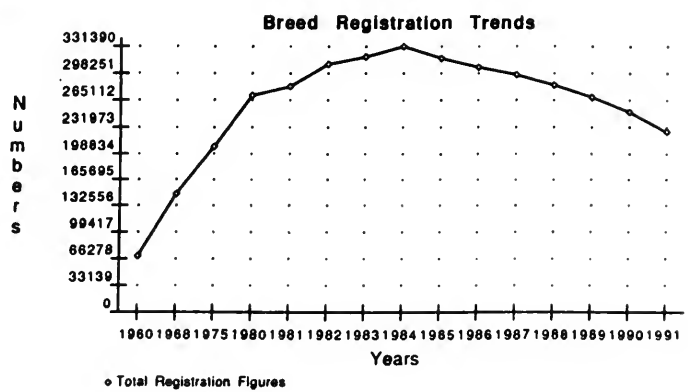
Reinstate Health Insurance Deduction for Self-Employed. Under current law an incorporated business can deduct the full cost of any health insurance provided for its employees. A self-employed individual, however, operating as an unincorporated business can only deduct this cost for himself and his dependents to the extent it, together with other medical expenses, exceeds 7.5% of adjusted gross income.

Prior to July 1, 1992 a self-employed individual was allowed to deduct up to 25% of the amount paid for health insurance for himself, his spouse and dependents. The President's proposal would extend the 25% deduction retroactively through 1993. The AHC supports this change.

Many individuals in the industry are self-employed, such as trainers, jockeys, drivers, and veterinarians. It is unfair to allow those who operate in corporate form to deduct health insurance costs for themselves but not those operating as sole proprietors or partners. As the Administration is well aware the costs of health insurance are substantial. Having the cost, even just part of it, deductible could mean the difference between a person having health insurance or not. The AHC supports this provision.

BREED REGISTRATION FIGURES 1960 - 1991

	1960	1968	1975	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Anglo & Half Arabian	2,200	9,800	11,351	10,017	9,752	8,247	8,052	9,200	9,654	6,645	8,200	8,500	4,775	4,276	4,251
Appaloosa	4,052	12,389	20,175	26,384	16,274	25,317	22,184	17,674	16,169	14,651	12,589	12,317	10,746	10,889	9,902
Arabian	2,084	6,974	15,656	19,726	20,261	24,937	18,391	29,176	30,004	28,263	26,421	24,669	21,723	17,878	12,993
Hackney	459	858	999	595	801	766	631	733	744	791	621	866	779	609	731
Miniatures	0	0										3,986	4,636	5,780	6,278
Morgan Horse	1,069	2,134	3,400	4,537	4,785	4,200	5,317	5,411	4,638	4,329	3,803	3,628	3,732	3,818	3,392
National Show Horse	0	0	0	0	0	1,470	1,018	782	868	927	1,011	978	919	733	624
Paint	0	2,390	5,896	9,654	9,411	13,683	13,626	12,034	12,692	11,273	15,618	14,929	14,390	18,163	18,648
Palomino	657	1,262	1,710	1,637	1,880	1,952	1,841	3,647	1,301	1,618	1,719	1,747	2,090	1,698	1,564
Paso Fino	0	0	380	845	859	712	693	1,155	1,335	1,323	1,249	1,464	1,453	1,550	1,483
Quarter Horse	35,507	65,326	97,179	137,090	148,785	155,401	168,346	169,675	157,380	153,773	147,007	126,352	123,294	110,597	101,390
Racking Horse	0	0										4,475	3,500	4,500	4,500
Saddlebred	2,329	3,569	4,064	3,686	3,621	3,132	2,787	5,164	4,351	4,363	3,918	3,811	3,708	3,589	3,570
Standardbred	6,413	10,682	12,830	15,219	17,432	20,086	20,298	19,795	18,364	17,637	17,579	17,393	16,896	16,678	13,617
Tennessee Walker	2,663	6,493	6,591	6,854	6,902	7,279	7,561	7,760	7,612	6,760	8,712	8,983	8,850	7,972	7,852
Thoroughbred	12,901	22,911	28,271	35,679	38,670	42,894	47,236	49,244	50,429	51,293	50,917	49,219	48,218	43,571	37,442
Total Registration Figures	70,334	148,898	208,604	270,723	281,233	310,069	317,981	331,390	318,848	308,468	297,264	283,118	289,699	249,627	227,237



STATEMENT BY
RAYMOND A. LEWIS, PRESIDENT
AMERICAN METHANOL INSTITUTE

HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS
HEARING ON PRESIDENT CLINTON'S
PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION

APRIL 6, 1993

It is my pleasure to present this Statement addressing the scope of the Administration's proposed BTU tax on behalf of the American Methanol Institute ("AMI"). AMI members produce virtually all of the methanol used as a chemical feedstock and as a fuel in the United States.

In the United States, methanol is produced almost entirely from abundant supplies of domestic natural gas. In recent years, the quest for cleaner urban air has caused an increase in demand for methanol and other alcohol fuels products. Over one-fourth of the methanol currently marketed in the United States is used to manufacture MTBE (methyl tertiary butyl ether), the most widely-used clean-fuel gasoline additive today. In addition, all of the major U.S. automakers now sell "flexible fueled" automobiles which can operate on methanol, and methanol-fueled buses and trucks are growing in use. Indeed, methanol is a remarkably safe and efficient fuel, having been used as the sole fuel for the Indianapolis 500 for the last 28 years.

As modified by the Administration on April 1, 1993, the proposed BTU tax would not be imposed upon ethanol, methanol, ETBE (ethyl tertiary butyl ether), MTBE, and feedstocks used in their production. AMI supports this BTU tax proposal modification because it treats all alcohol fuels in the same manner. This even-handed treatment of methanol and ethanol reflects sound tax policy because it does not use the tax law to favor one product over another. Unfortunately, several provisions of current law do provide an unfair tax subsidy for ethanol which discriminates against methanol.

Under current law, ethanol enjoys a number of unfair tax subsidies, particularly an alcohol fuels credit under Internal Revenue Code section 40 of between 54¢ and 64¢ per gallon, without which ethanol would not be competitive as a fuel. Moreover, under Treasury Regulation § 1.40-1 a credit is available for ETBE, an ether created through a chemical reaction of ethanol and isobutylene (a petroleum biproduct), even though the section 40 credit is expressly limited by statute to "alcohol," not to chemicals produced from alcohol. These credits are not available to methanol and MTBE produced from natural gas. For companies that do not pay income taxes and cannot use the section 40 credit, a substantial reduction in fuel excise taxes is available for ethanol and ETBE.

Ethanol supporters argue that it deserves special tax treatment because it is made from corn and sugar cane produced by American farmers. However, encouraging the extraordinary production of crops by creating an artificial demand for those crops used to make a product that cannot compete in the marketplace without subsidies is not helping consumers or taxpayers. The market, not the tax law, should dictate demand and investment, a concept adopted by this Committee as the basis for the Tax Reform Act of 1986. Accordingly, we applaud the Administration's fuel-

neutral decision to treat both ethanol and methanol the same under the BTU tax and urge the Committee to adopt this tax neutral posture. In addition, we ask the Committee to apply this principle of tax parity in its consideration of any further legislative tax preferences for ethanol, such as repeal of section 87, which provides for the inclusion of the ethanol tax credit in taxable income.

We note that as proposed by the Administration, the BTU tax would be imposed on all natural gas, and the exemption for methanol and MTBE would be provided through a downstream refund or credit mechanism to the methanol manufacturer. In a situation where the natural gas is used for the production of methanol, such a credit refund mechanism appears cumbersome at best. We suggest that the imposition of the BTU tax on natural gas should not apply when the natural gas is used as a feedstock for an exempt product. This would simplify the administration of the tax.

AMI also would like to take this opportunity to articulate its position with respect to a written comment submitted by Daniel Lashoff, senior scientist for the National Resources Defense Council, on March 23, 1993. Mr. Lashoff's statement implies that a lower tax rate for alcohol fuels could lead to imports, "especially of methanol".

AMI shares Mr. Lashoff's concern that domestic producers not be put at a disadvantage compared to imported methanol. However, the domestic methanol industry has already begun to expand rapidly to meet the growing demand for clean fuels and fuel additives. Even if the price of foreign natural gas remains significantly lower than the price of U.S. gas, methanol for the U.S. market will continue to be more profitably produced from domestic natural gas. Overseas, and particularly in countries with the lowest gas prices, those benefits are wiped out by the high costs of construction and political risk. Add the greater costs for shipping, storing and handling foreign methanol for the U.S. market, and it becomes clear why the methanol industry is investing in America to produce for the American market.

The Administration's decision to exempt all clean burning alcohol fuels will encourage further domestic construction and significantly expand the use of domestic natural gas-based methanol to displace imported petroleum. We strongly urge the Committee not to interpret Mr. Lashoff's remarks as a rationale for a higher tax rate on methanol -- particularly if this would result in a disparity of tax treatment between ethanol and methanol.

In summary, AMI supports the Administration's BTU tax proposal modification because it does not favor one alcohol fuel over another. Rather, all alcohol fuels are treated in the same manner. We urge the Committee to adopt this principle of tax parity among alcohol fuels in its consideration of the proposed BTU tax as well as in its consideration of other proposed tax preferences for ethanol.

Before the
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
Washington, DC

Comments of the
AMERICAN MOVERS CONFERENCE
and
HOUSEHOLD GOODS CARRIERS' BUREAU
on
TAX PROPOSALS FOR STIMULUS AND DEFICIT REDUCTION

The American Movers Conference and the Household Goods Carriers' Bureau (AMC/HGCB) represent over 3,000 household goods moving companies nationwide. These companies represent the entire spectrum of America's transportation service industry from large corporations to small companies. On behalf of these members, AMC/HGCB offers the following comments on President Clinton's economic plan.

INTRODUCTION

The household goods moving industry is comprised of national van lines, agents of van lines, and independent van lines. The moving industry employs over 500,000 people, including owner-operator truck drivers, employee truck drivers, packers and helpers, and warehousemen, as well as office personnel. This is not an industry of highly compensated personnel but an industry of hard-working people living in virtually every community in this country.

The last decade has been difficult for this industry and the people who work in it. One of the Interstate Commerce Commission's (ICC) measures of financial stability in the trucking industry is the operating ratio. The ICC indicates that a carrier should retain between 6% to 7% (i.e. 93% to 94% operating ratio) of its operating income to cover interest payments, taxes, miscellaneous other deductions, and retention of capital for asset acquisition. The household goods moving industry has been able to retain only 2.5% or less of its operating income. As a result, the moving industry cannot be characterized as financially healthy.

Therefore, this is an industry which should not suffer but must benefit from the President's economic package. AMC/HGCB's concern is simple: Congress should not single out this industry for revenue raising purposes.

THE MOVING EXPENSE DEDUCTION

AMC/HGCB supports the President's treatment of the moving expense deduction. If it is necessary to raise revenue through limitations of moving expense deduction, the proposal denying the deduction for real estate closing costs and meals makes sense. There is little doubt that these changes will increase the cost of relocating and will therefore adversely effect household goods carriers. However, it will not severely limit the mobility of workers in this country.

As demonstrated in the study entitled "Tax Treatment of Moving Costs: The Economic Impact on a Growing Economy" which was jointly commissioned by the American Movers Conference and the Employee Relocation Council, a mobile work force is essential for a healthy economy.* Although the authors assert that current law restricts the moving expense deduction too much, AMC/HGCB is comprised of economic realists. Revenue raising measures are essential for this economic package and AMC/HGCB in turn asserts that the Administration's proposal raises substantial revenue from a limited number of taxpayers and a relatively small industry.

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*The study, co-authored by Eugene Steuerle, former Deputy Assistant Treasury Secretary, and Joseph Cordes, chairman of the Economics Department at George Washington University and former Deputy Director of the tax division of the Congressional Budget Office, was submitted for the record by the Employee Relocation Council.

Therein lies the concern. Last year. H.R. 11 severely limited the moving expense deduction by placing a $10.000 cap on the amount individuals could deduct. This cap would have seriously hurt the moving industry and its workers. It would have also jeopardized an individual's opportunity to relocate to retain a job or seek new employment. As weekly lay-offs and cut-backs continue to be announced in this country. a cap represents poor tax and economic policy. AMC/HGCB urges Congress to reject any further proposals for a cap on the moving expense deductions.

ENERGY TAX AND MEALS DEDUCTION

The Administration's proposal to implement a broad-based energy tax will fulfill the revenue objectives of the legislation. Although AMC/HGCB understands the funding realities. we are concerned that the tax rate for fuel. including diesel. is at a basic rate more than twice that of coal and natural gas. In 1991. gas and fuel represented over 20% of a household goods owner-operator's expenses. This was a four percent increase from 1990. Household goods owner-operators do not have the ability to buy from bulk facilities and a substantial increase will directly effect their ability to stay in business. AMC/HGCB encourages this Committee to explore comparable rates which would allow for a more even-handed approach of all energy sources. Additionally. AMC/HGCB recommends that the Committee specifically address mechanisms available to trucking companies to pass on any increased costs to shippers.

The decrease in the meals deduction will also have a direct effect on household goods owner-operators and their business stability. The over-the-road truck driver may be on the road 200 days a year. In 1991, their meals and lodgings averaged $10,388 per year or 10.7% of their revenue. Although the Administration may have intended a decrease in the meals deduction to impact highly compensated executives who have a wide range of entertainment and dining choices. it also will adversely effect truck drivers who pay truck loans. maintenance and repair expenses. fuel costs, and taxes before feeding a family. An exemption for over-the-road drivers is appropriate.

CONCLUSION

This Committee is faced with a complicated process. The household goods moving industry recognizes the serious issues and the constraints before the Committee and Congress. The President's proposal will raise substantial revenue from the household goods moving industry through the changes in the moving expense deduction. This Committee and Congress should reject any proposal to institute a cap on moving expenses.

This industry recognizes the need for revenue sources but AMC/HGCB urges the Committee to explore comparable BTU tax rates to alleviate some of the burden which the energy tax will impose on those individuals and companies which depend on fuel to earn a living. Finally, we urge the enactment of an exemption for truck drivers from the reduction of the meals deduction.

The Administration and the Congress have before them a difficult task. AMC/HGCB stands willing to work with this Committee and the Administration. This industry's financial well-being is interwoven with the economic health of this country and with the right proposals we all stand to gain.

AMERICAN MOVERS CONFERENCE
HOUSEHOLD GOODS CARRIERS' BUREAU

Joseph M. Harrison
President

Ann Wilson

Ann Wilson. Director
Legislative and Regulatory Affairs

April 1993

A S P A
Dedicated to the Private Pension System

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This written statement is hereby submitted by the American Society of Pension Actuaries for inclusion in the record relative to the Congressional hearings conducted by the Committee on Ways and Means on President Clinton's proposals for public investment and deficit reduction. ASPA is an organization of 3,000 members who provide actuarial, consulting, and administrative services to approximately one-third of the qualified retirement plans in the United States.

The specific item on which we wish to comment is President Clinton's proposal to reduce the amount of compensation on which benefits can be based under qualified retirement plans, from $235,840 to $150,000 (Internal Revenue Code section 401(a)(17) limit). This item appears on page 41 of the "Summary of the Administration's Revenue Proposals" (Department of the Treasury, February 1993.) Such a reduction would result in a diminution of the ability of the private pension system to provide substantial retirement benefits to millions of Americans and its ability to provide vital investment capital to fuel economic growth.

This proposal should be considered in the context of what has occurred during the last decade:

Benefit Cuts

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the maximum benefit under a defined benefit plan from $136,435 to $90,000, and reduced the maximum contribution under a defined contribution plan from $45,475 to $30,000. The Tax Reform Act of 1986 applied the $90,000 limit at age 65 instead of age 62, with actuarial reductions for benefits at earlier ages. It also eliminated the $75,000 floor for actuarial reductions for retirement at age 55 or older. The defined benefit limit was frozen at $90,000 from 1983 through 1987 with indexation beginning in 1988, and is currently $115,641. The $30,00 defined contribution limit will not be indexed until the defined benefit limit reaches $120,000.

Increased Complexity

A myriad of statutes in the last decade continually changed the rules under which qualified retirement plans must operate, substantially increasing their administrative costs. Major changes to these rules were made in TEFRA '82, the Deficit Reduction Act of 1984 (DEFRA), the Retirement Equity Act of 1984 (REACT), the Tax Reform Act of 1986 (TRA '86), the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), the Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88), and the Omnibus Budget Reconciliation Act of 1990 (OBRA '90).

The burden of increased complexity combined with diminished maximum benefits caused private retirement plans to be terminated in record numbers. Although the growth of the private pension system since World War II has increased benefit pay-outs and the amount of the reserves held by private plans, in recent years there has been a substantial decline in the percentage of the working population covered.

A study by the Social Security Administration's Office of Research and Statistics, released in August 1989 by the Department of Health and Human Services, demonstrated that there has been a decline in pension coverage in the 1980s, (from 50 percent of workers in 1979, to 44 percent in 1988), and that this decline has been most acute in defined benefit plans, which provide definitely determinable benefits at retirement. Department of Labor statistics, for example, indicate that in 1985 there were 224,474 defined benefit plans, and that by 1989, this number had been reduced to 132,467. Subsequent statistics indicate that the decline in the percentage of workers covered under qualified plans is continuing.

Before the enactment of TEFRA in 1982, our nation's retirement policy encouraged the formation and maintenance of private retirement plans and, not surprisingly, new plans were established in record numbers.

The consequences of a cut in the section 401(a)(17) limit to $150,000 are predictable. Larger employers will put increasing emphasis on unfunded, nonqualified plans, which have no discrimination standards. Such plans are not feasible for most small employers because the financial situation of such employers generally is too tenuous. Small employers will have less incentive to adopt or continue qualified plans, and coverage of small business employees will certainly decrease.

The government should take every feasible step to encourage, rather than discourage, the growth of qualified retirement plans. The reserves under private qualified plans are currently approximately $3 trillion. In fact, a recent study indicates that the total increase in real (inflation-adjusted) pension assets in the 1980s exceeded the total real increase in the country's wealth; in other words, these assets provided for all of our national savings during this period. Without these assets our economy would be starved for capital. Of course qualified retirement plans are an essential element in providing adequate retirement security to an aging population. ASPA urges this Committee to oppose the cut in section 401(a)(17) limit, or any other proposal, such as a cut in the section 415 maximum benefit and contribution limits, which would diminish the future growth of qualified private retirement plans.

The section 401(a)(17) proposal and the statutes enumerated above have been formulated on an ad hoc basis without consideration for the negative effect on the long term health of the qualified retirement system and its impact on our economy. ASPA believes that America needs a national retirement income policy to replace this flawed approach. The creation of a joint congressional-presidential national retirement income commission is a vital step toward a long term perspective. Bills to create such a commission have been introduced during this session of Congress. Rep. Hughes (D-NJ) has introduced H.R. 199, to establish a Commission on Retirement Income Policy and Senator David Pryor [D-AR] has introduced S. 762, the Employee Benefits Simplification Act, which also includes provisions establishing such a commission. ASPA urges the Committee on Ways and Means to support the establishment of a national retirement income commission.

American Wind Energy Association

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STATEMENT OF MICHAEL L. MARVIN, DIRECTOR, GOVERNMENTAL AND PUBLIC AFFAIRS, THE AMERICAN WIND ENERGY ASSOCIATION SUBMITTED TO THE COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES CONCERNING PRESIDENT CLINTON'S PROPOSALS FOR PUBLIC INVESTMENT AND DEFICIT REDUCTION APRIL 6, 1993

The attached comments are submitted on behalf of the American Wind Energy Association, a trade association has representing all facets of the U.S. wind energy industry since 1974. Its more than 700 members in 49 states include turbine manufacturers, utilities, components manufacturers, project developers, academicians and interested individuals. The Association is located at 777 North Capitol Street, Northeast, Suite 805, Washington, D.C. 20002, tel (202) 408-8988.

The attached comments make the following points:

1. The American Wind Energy Association supports President Clinton's proposed permanent investment tax credit on equipment for small businesses and temporary incremental investment credit for large businesses if all energy sources are treated similarly.

2. AWEA supports the exemption of non-polluting renewable energy source of electricity such as wind, solar and geothermal energy, from the President's proposed Btu tax.

3. Section 1914 of the Energy Policy Act of 1992 provides a 1.5 cent per kilowatt-hour production tax credit for wind- and "closed loop" biomass-generated electricity. Both the permanent small business credit and the temporary big business incremental credit would reduce the wind production credit. AWEA believes that section 45(b)(3)(A)(iv) should be amended to allow wind and closed-loop biomass energy systems to be eligible for President Clinton's proposed investment tax credit to ensure that wind and closed-loop biomass facilities are not treated differently than other forms of energy, whether renewable or conventional.

4. The President has proposed to provide relief from the alternative minimum tax (AMT) for capital intensive businesses and to simplify the AMT for corporations by allowing taxpayers to use a single recovery period for computing depreciation. Despite this proposed modification, wind energy development's capital intensity generally will preclude the use of the production credit even with the President's requested modification.

It is submitted that, until passage of the Energy Policy Act of 1992, Congress has favored the development of all competing domestic energy forms -- except wind energy -- with various tax incentives. In an effort to reduce the inequity in the federal energy tax code, Congress passed a 1.5 cent per kilowatt-hour production tax incentive for electricity generated by new wind power plants installed between January 1, 1994 and June 30, 1999.

President Clinton's proposed investment tax credit designed to stimulate investment in small business would have what AWEA believes is an unintended effect of creating additional obstacles for wind and closed-loop biomass energy systems by making these technologies the only forms of energy ineligible to receive such an incentive.

AWEA submits that any investment tax credit passed by Congress should not discriminate against wind and closed loop biomass, and that the provision be modified to follow the solar and geothermal credit (section 48).

I. AWEA Supports President Clinton's Proposed Economic Plan

AWEA supports President Clinton's economic package, and has communicated that support to the Clinton Administration. AWEA believes that deficit reduction should be a central focus of the 103rd Congress. Long-term deficit reduction, however, should rely on economic growth of the private sector. The American wind industry has invested more than $3.0 billion in wind technology, but that investment merely scratches the surface of wind energy's potential to generate cost-effective energy around the world while simultaneously creating vital jobs in the U.S. and contributing positively to the country's international balance of trade.

II. AWEA Supports the Exclusion of Maturing, Non-polluting Renewable Energy Technologies from the Proposed Btu Tax

AWEA supports the President's proposed exemption of non-polluting renewable technologies such as wind and solar from the Btu tax. Although the economic benefits of such an exclusion are relatively insubstantial, AWEA believes that such an exclusion sends a powerful message to the utility and capital markets that renewable energy technologies serve an important national role and will continue to be emphasized as part of this nation's energy future.

III. AWEA Supports an Investment Tax Credit for Small Business that Treats All Renewable Energy Sectors Equally

As Part of the Comprehensive National Energy Policy Act of 1992, this Committee included an incentive for wind and biomass generated electricity production. This Committee sought to encourage commercial wind and biomass development through a 1.5 cent per kilowatt-hour tax credit for electricity generated from projects placed on line between January 1, 1994 and June 30, 1999. The credit would be received for electricity generated during the first 10 years of a project's life. Although Bush Administration officials believed that it would require a tax credit of 2.0 cents per kilowatt-hour to achieve tax equity, and most House Energy and Power Subcommittee members believed that tax equity would be achieved at 2.5 cents per kilowatt-hour, the industry nonetheless is appreciative of this Committee's efforts.

The gains in Title IX of EPA '92, however, could be substantially nullified by a provision in the production tax credit (Section 1914 of the Energy Policy Act of 1992), which reduces the production credit by, *inter alia*, "the amount of any other credit allowable with respect to any property which is part of the project".

AWEA believes that provision was included to ensure that other credits received in previous years could not be applied simultaneously with the production tax credit. This anti-double dipping provision did not anticipate the enactment of President Clinton's economic stimulus program. Both the permanent small business credit and the temporary big business incremental credit would reduce the wind energy production credit, while having no effect on credits currently available to wind energy's competitors. We request that the production credit offset found in Section 45(b)(3)(A)(iv) not apply to the proposed investment credit -- both the temporary incremental credit for big businesses and the permanent credit for small businesses.

Denying the proposed investment tax credit only to wind and biomass would place these new technologies at a singular disadvantage at a time when the country and the world are placing greater emphasis on non-polluting sources of electricity generation.

IV. President Clinton's Proposal to Provide Relief from the Alternative Minimum Tax for Capital Intensive Industries

The President proposes to provide relief from the AMT for capital intensive businesses and to simplify the AMT for corporations by allowing taxpayers to use a single recovery period for computing depreciation. Our companies are extremely capital intensive and will continue to be subject to the AMT even with the President's proposed modification. Consequently, our

companies will not be able to avail themselves of the AMT credit to mitigate the alternative minimum tax over the long-term nor, for that matter, will they be able to utilize the production credit.

Congress intended to encourage wind electric generation facilities through the section 45 production credit, but the production credit cannot be used to offset the alternative minimum tax. The AMT is thus a disincentive for investments in wind electric generation facilities. It is therefore suggested that this Committee consider additional measures to permit the production credit to achieve the intended result. An additional relief provision would be to allow the production credit to partially offset the alternative minimum tax.

The new Administration has a clearly-stated vision of America's energy future. As both candidate and President Clinton have said, the country must focus on an energy triad of energy efficiency, renewable energy and natural gas.

The nation's economy, its energy future and its environmental quality are inextricably linked. Studies continue to show that wind energy is by economically viable, environmentally benign and produces more jobs per unit of energy than any other source, conventional or renewable. AWEA requests this committee's support in enacting the preceding four provisions.

The President also has expressed his support for using the federal tax code to encourage investment in renewable energy and energy efficiency. AWEA submits that any exclusion of wind and biomass from an investment tax credit would run directly counter to Congressional and Administration efforts to provide equity in the federal energy tax code. We urge the Committee to modify Section 45(b)(3)(A)(iv) to allow equal treatment for wind and biomass energy.

STATEMENT BY THE ASSOCIATION OF LOCAL HOUSING FINANCE AGENCIES

Mr. Chairman and Members of the Committee:

The Association of Local Housing Finance Agencies (ALHFA) appreciates the opportunity to provide its statement of support for the President's economic package recommending permanent extensions of the Mortgage Revenue Bond/Mortgage Credit Certificate and Low-Income Housing Tax Credit programs. At the outset, ALHFA strongly urges the Committee to approve the President's recommendation and include permanent extensions in the budget reconciliation legislation.

By way of background, ALHFA is a nonprofit national association of professionals in the field of affordable housing finance. Its members are primarily city and county government agencies which finance from a variety of sources including federal tax code incentives homeownership and rental housing opportunities for low- and moderate-income households. Among its members are the City of Chicago's Department of Housing, the New York City Housing Development Corporation, the City of Los Angeles Department of Housing Preservation and Production, the San Francisco Mayor's Office of Housing and many, many more. ALHFA's purpose is to serve its members as an advocate before Congress and the Executive Branch on affordable housing policy issues and, through educational activities, to enhance the ability of local housing agencies to implement responsible and professionally administered affordable housing programs.

Mr. Chairman, Mortgage Revenue Bonds and Low-Income Housing Tax Credits are absolutely critical to the creation and rehabilitation of decent housing for low- and moderate-income people. In addition, MRBs and LIHTCs are essential tools for addressing the growing problem of blighted conditions and disinvestment in our urban neighborhoods.

MORTGAGE REVENUE BONDS

Mortgage Revenue Bonds are issued by local and state housing finance agencies to provide mortgage assistance for low- and moderate-income, first-time homebuyers – the people that the conventional mortgage market often leaves behind. Typically, tax-exempt bond-financed interest rates are 1.5 percent below the conventional rate. This translates into the ability to qualify households at lower incomes, as well as the ability to reduce the monthly mortgage payments of those assisted. Eligible households may have incomes no higher than 115 percent of the area median income for households of three or more persons (100 percent for those households with less than three persons). The purchase price of eligible homes may not exceed 90 percent of the average purchase price of homes in the area. Both the purchase price and income restrictions are relaxed in certain defined target areas.

The authority to issue MRBs/MCCs expired on June 30, 1992. Legislation making the program permanent, H.R. 11, the Revenue Act of 1992, was vetoed by then-President Bush the day after the 1992 Presidential election. Rep. Barbara Kennelly (D-CT) has introduced H.R. 462, legislation to make the program permanent. That bill currently has 170 cosponsors. Companion legislation, S. 348, has been introduced in the Senate by Sens. Riegle (D-MI) and Chafee (R-RI). It currently has 41 cosponsors. Immediate Congressional passage of legislation making the program permanent is among the highest priorities of ALHFA.

Local housing finance agencies use the Mortgage Revenue Bonds for one or more public purposes:

- Providing homeownership opportunities for low- and moderate-income households;
- Promoting new affordable housing construction (through builder set asides);
- Stimulating housing rehabilitation and home improvements;
- Promoting substantial rehabilitation and thereby encouraging neighborhood revitalization;
- Stabilizing and improving neighborhoods through homeownership;
- Providing mortgage assistance to first-time homebuyers acquiring RTC and FHA foreclosed properties; and
- Utilizing publicly held land inventory.

In 1992, local housing finance agencies issued \$2.73 billion (\$2.59 billion in lendable proceeds) of that year's \$9.23 billion in Mortgage Revenue Bond volume. The balance was issued by state agencies. From this amount, an estimated 36,049 loans were made. The average loan amount was \$ 71,846, made to eligible households whose incomes averaged \$ 30,855 – 80 percent of the 1992 national median income of \$38,600 and 7 percent lower than the income of the average first-time homebuyer using conventional financing – \$42,300. The MRB-assisted average loan amount is 71 percent of the average amount of a first-time homebuyer's conventionally financed \$100,200 home

loan. Thus, it is clear from these statistics that local MRB programs are sharply targeted, in keeping with Congressional intent.

Pittsburgh
Several examples of exemplary, highly targeted local agency MRB programs are Pittsburgh's, developed by the Urban Redevelopment Authority to help respond to declining population and deteriorated housing stock in need of redevelopment. The MRB programs are an essential element of a comprehensive set of housing programs designed to meet the City's housing needs.

The Authority operates various MRB funded programs that promote homeownership and encourage home rehabilitation.

Pittsburgh Home Ownership Program

The Pittsburgh Home Ownership Program (PHOP) provides low interest first mortgage loans to qualified first-time homebuyers throughout the City from the proceeds of the sale of tax-exempt bonds. PHOP promotes neighborhood revitalization in targeted neighborhoods when coupled with the Authority's second mortgage programs. It is also designed to attract new residents to the City through these incentives. Since its inception in 1979, PHOP has provide over $155.4 million in finance for the issuance of 4,167 loans which purchased 4,864 housing units. In 1992, the average income of the PHOP borrower was $26,235 (73 percent of median income), and the average sales price of the housing units was $44,351 (48 percent of the average area purchase price). Of the 276 borrowers assisted, 26 percent had incomes below $20,000 (55 percent of median income), while an additional 41 percent had incomes below $30,000 (83 percent of median income).

Housing Recovery Program

The objective of the Housing Recovery Program (HRP) is to stimulate the acquisition and rehabilitation of substandard or vacant structures in targeted neighborhoods. The Authority created this program in an effort to address the problem of increasing residential abandonment in these areas. The program is funded through the issuance by the Authority of tax-exempt qualified rehabilitation bonds, funds from the State of Pennsylvania, and Community Development Block Grant funds.

In 1992, HRP financed 51 loans for the rehabilitation of 66 substandard or vacant houses. The total financing exceeded $3.3 million. The average income of the homebuyer was $28,522, and the average acquisition/renovation cost was $65,669. Since the program's inception, HRP has financed the rehabilitation of 190 housing units with a total value exceeding $6.7 million.

Pittsburgh Home Rehabilitation Program

The Pittsburgh Home Rehabilitation Program (PHRP) provides 0% interest loans to very low-income homeowners (below 60 percent of the median) to help them rehabilitate their homes. PHRP operates with bond proceeds and CDBG funds. General property improvements financed by this program may be made after repairing building code violations and making energy saving improvements.

In 1992, the Authority made 209 PHRP loans valued at nearly $3.4 million. The average income of the homeowner assisted was $11,805, and the average loan/grant amount was $16,240. Over 49 percent of the low-income homeowners were elderly. Since this program began funding loans with bond proceeds in 1990, PHRP has provided over $5.9 million in financing for the rehabilitation of 406 citywide.

Home Improvement Loan Program

The Home Improvement Loan Program (HILP), begun in 1978, provides financial and technical assistance to low- and moderate-income borrowers citywide. There are two components: regular loans made from bond proceeds for any type of home improvement that is eligible for insurance under the FHA Title I program; and subsidized loans, where bond proceeds are combined with Community Development Block Grant funds to make loans to lower income persons. Those assisted must first repair any City housing code violations before making any general improvement.

Under HILP, for the period 1978 to the end of 1992, the Authority has provided nearly $82.8 million in tax-exempt bond financing to fund 9,781 regular and 4,042 subsidized loans, with an

average loan amount of $5,987 under the regular and $7,818 under the subsidized program. The average income of the borrower over this time has been $20,084 for the regular and $14,128 for the subsidized program. In 1992, the Authority made $1.3 million in bond financing, together with $203,353 in CDBG funds, from which 89 regular and 73 subsidized loans to borrowers having average incomes of $30,718 (85 percent of median income) and $19,282 (53 percent of median income) respectfully.

Los Angeles

The City of Los Angeles is another excellent example of the use of Mortgage Revenue Bond financing in the inner city. The City is currently using the program to provide mortgage assistance for the largest single-family housing development in the Watts section since before World War II. The development has already had a ripple effect as other investment has been committed including a shopping center, performing arts center and a restaurant.

The City of Los Angeles set aside $6 million in Mortgage Revenue Bonds in 1991 to provide first mortgages beginning at 7.34 percent for the Santa Ana Pines development. The City is also allocating up to $1.5 million in additional funds to provide "soft second" mortgages which do not have to be repaid until the home is sold. The homes will sell for between $130,000 to $150,000 – 70 percent of the City's median home price of $215,000.

The expected profile of the buyer of these homes using both the first and second mortgage programs is $32,000 to $42,000 – 76 to 100 percent of the City's median income for a family of four. This is well below the MRB program's allowable limit of 115 percent of median.

In addition to benefitting both the homebuyer and the community, the City's use of the MRB program for Santa Ana Pines has provided an opportunity for a minority builder/developer to undertake the project by guaranteeing mortgage financing which he could in turn use to secure construction financing from a local lender. This is an excellent example of a public-private partnership. The development survived last spring's civil disturbances unscathed and is serving as a model for efforts to rebuild in the affected area.

In the aftermath of the civil disturbances last May, the program will be an essential component of the City's rebuilding efforts. Homeownership will add to community stability and hopefully widen the economic base of South Central Los Angeles.

Legislative Refinements

As Congress considers legislation to make the MRB program permanent, there are several recommendations which ALHFA urges be adopted to improve the program's effectiveness:

- Clarify that shared appreciation/subsidy lien second mortgage programs used in tandem with MRBs do not constitute an ownership interest on the part of the issuer, are excluded from the acquisition cost limits of the program, and have no effect on the "effective rate of interest" on first mortgage loans financed from an MRB issue. This is a technical change to clarify a grey area of the law in order to insure that second mortgage programs can be used with MRBs.

- Increase the ceiling on MRB-financed home improvement loans from $15,000 to $25,000. This would make the program consistent with the ceiling on the Federal Housing Administration's home improvement insurance program, which would be appropriate since the two programs are often used together. The MRB limit has been in place since the 1970s and does not reflect the increased cost of improving homes, particularly older homes.

- Exclude tax-exempt housing bonds from the Alternative Minimum Tax. The tax does not raise revenue, and it adds an average of 25 basis points in additional cost.

- Restore the deductibility of carrying costs of bank purchases of tax-exempt bonds when the proceeds of such bonds are used to fund mortgages in census tracts where at least 50 percent of the households have incomes below 90 percent of the median income. This would encourage investment in distressed areas.

MORTGAGE CREDIT CERTIFICATES

The Mortgage Credit Certificate (MCC) program, authorized by Congress in the Tax Reform Act of 1984, provides financial assistance to first-time homebuyers for the purchase of single-family homes, townhouses, condominiums, and mobile homes on foundations.

An MCC gives the homebuyer a federal income tax credit each year the buyer keeps the same mortgage loan and lives in the same house. Although variations are possible, the typical MCC tax credit equals 20 percent of the mortgage interest paid each year. That 20 percent is subtracted dollar-for-dollar from the homebuyer's federal income tax. The remaining 80 percent of the mortgage interest is taken as a deduction from gross income in the usual manner.

Local housing finance agencies make use of the MCC program where it is feasible and consistent with their housing needs and priorities. MCCs tend to be feasible in growing areas with relatively high incomes. It is in such areas that those assisted have sufficient taxable incomes to maximize the value of the credit. MCC programs are particularly popular in California where programs are operated by many local housing finance agencies, usually as a component of their MRB programs. In addition, the City of Chicago implemented an MCC program in 1992 and intends to expand it once the sunset is lifted.

But while MCCs work in some areas they do not work everywhere. In addition, MCCs do not generate mortgage capital since they rely solely on the available supply of market rate mortgages. Instead of the MRB front-end subsidy, MCCs are a back-end subsidy taken at the time a mortgagor files his or her income tax. In addition, MRBs can be used to provide capital for neighborhood revitalization through home improvement and qualified rehabilitation programs. Both the MRB and MCC programs are needed to respond in a comprehensive fashion to varying local housing needs.

Santa Clara County
One exemplary MCC program is that administered by Santa Clara County, Calif. The County lies at the south end of San Francisco Bay and has a population of 1,500,000.

Santa Clara County's MCC program is the largest in California. It began in November 1987 when eleven cities joined under the County's umbrella to create a single program. Since then, the County has issued about 6,500 MCCs to assist first-time homebuyers. Assistance is aimed at low- and moderate-income households who have been priced out of the local housing market.

While incomes in Santa Clara County are high relative to national norms, housing prices are even higher. Income limits in the County for 1993 are $59,500 for a household of one or two persons and $68,425 for a household of three or more. These are the maximums allowed by federal law.

Santa Clara County has some of the highest housing costs in California. According to Ernst & Young Real Estate Advisory Services, the San Jose SMSA (Santa Clara County) is the eighth least affordable housing market in the nation.

The Average Area Purchase Prices (AAPPs) for Santa Clara County are $279,268 for existing residences and $354,728 for new residences. Federal law limits purchases to houses that don't exceed 90 percent of those numbers. However, the County has set lower maximums: $220,000 for existing homes, which is 78.7 percent of the AAPP of $279,268, and $250,000 for new homes, or 70.5 percent of the AAPP of $354,728. In 1992, nearly 70 percent of all MCC recipients purchased existing homes costing less than $187,000–about 67 percent of the AAPP.

In part this results from targets set by the County program. Large portions of the city-by-city allocations are reserved for households earning 80 percent of the median income or less, and for houses costing less than 67 percent of the AAPP. Most of the lower cost units are in San Jose, which reserves 80 percent of its allocation for those lower cost units. And most of the county's Mortgage Credit Certificates are issued in San Jose. It is the county's largest city and has the largest stock of affordable housing for first-time buyers. Overall, the county program allows some MCC recipients to buy homes costing over $187,000 but less than the maximums of $220,000 for existing homes and $250,000 for new homes. Allowing MCC recipients to purchase some higher cost units spreads the MCCs into the other (higher cost) cities in the county and over a wider area. In 1992, 1,243 MCCs were issued in the county. The average MCC issue amount was $29,813 (20 percent of the average mortgage amount of $149,068).

Average household income of MCC recipients in Santa Clara County was $44,000 in 1990, $46,000 in 1991, and $47,092 in 1992, always averaging 80 percent of the County median income. Forty-six percent of Santa Clara County MCC recipients are households of one person; 30 percent have two persons; and 24 percent have three or more persons. Fifty-seven percent are white, 43 percent are minority. Eighty-two percent of the recipients needed the MCC to qualify for the unit they were buying.

LOW-INCOME HOUSING TAX CREDITS

The Low-Income Housing Tax Credit program was enacted by Congress to stimulate private investment in the acquisition, rehabilitation, or construction of rental housing for low-income persons. Conceptually, the Credit represents a legitimate use of the tax code to stimulate investment in an activity which otherwise would draw little, if any, investor interest. The reason, of course, is that rental housing projects are not an economic investment and must rely on other factors, such as tax benefits, to make them attractive.

In addition, the type of project to be assisted – one which contains, at a minimum, a certain percentage of units set aside for low-income persons (20 percent at or below 50 percent of median or 40 percent at or below 60 percent) – is also, conceptually, proper federal housing policy. It is designed to target assistance to low-income persons, and it reflects lessons learned from previous federal housing programs – that mixed-income projects promote a positive housing attitude and environment.

But while the Credit is fine in concept, it currently suffers from a serious shortcoming which limits its effectiveness. The Credit by itself is of insufficient value to stimulate a significant amount of new, mixed-income rental housing in the absence of additional subsidies. That is, generally it is not possible to achieve the targeting required using only the Credit. Projects simply do not pencil out.

In addition, when tax-exempt bonds or federal grants or loans (other than those made with Community Development Block Grants) such as HOME Investment Partnerships Program funds are used, a penalty is imposed reducing the Credit from 70 percent present value to 30 percent present value.

Those projects which have used the Credit have involved for the most part situations where nearly 100 percent of the units are and will remain low-income. In such projects, the Credit is maximized by its application to all of the units. This in our view biases the program away from mixed-income developments, thereby ignoring the lessons learned from previous housing policy. Tax-exempt bonds are a critical component of the debt side of a housing project. The Credit helps on the equity side. Removing the penalty which reduces the value of the Credit when used with bonds or other federal programs such as HOME would directly assist local housing finance agencies to stimulate production of a significant amount of new, mixed-income rental housing. This would not only add to the stock of low-income housing, but it would also create a positive housing environment for the low-income persons who are its occupants. Congress took an important step in this direction in 1989 when it modified the tax law to allow use of the 70 percent credit in conjunction with below market interest rate loans from CDBG funds. ALHFA urges the Committee to complete the process by permitting the use of up to the 70 percent credit (91 percent in high cost areas) when used with tax-exempt bonds and other federal programs such as HOME. Present law would ensure that such a combination would not result in over-subsidizing a project, as allocating agencies would be required to provide only the amount necessary to achieve project feasibility.

Since its enactment as part of the 1986 Tax Act, the tax credit has produced over 500,000 units of rental housing. In 1992 it accounted for more than one-half of all the multifamily construction activity, producing an estimated 50,000 jobs.

Authority for state (and certain local) agencies to allocate tax credits expired on June 30, 1992. A provision making the credit permanent was included in H.R. 11, last year's vetoed tax bill. Two bills to make the credit permanent have been introduced in the House, H.R. 18 by Ways and Means Committee Chairman Dan Rostenkowski (D-IL), which currently has 134 cosponsors. Sens. George Mitchell (D-ME) and John Danforth (R-MO) have introduced S. 487 which would make the program permanent. It currently has 19 cosponsors. ALHFA urges Congress to enact a permanent extension at the earliest possible time.

Thank you for the opportunity to present ALHFA's recommendations on the President's economic package.

Center for the Study of Economics

2000 Century Plaza, #238
Columbia, MD 21044
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March 23 1993

COMMITTEE ON
RECEIVED
MAR 26 1993
WAYS AND MEANS

Ms Janice Mays, Chief Counsel & Staff Director
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms Mays:

I was out of the country when hearings were held on the deficit and enterprise zones (see your Press Release #4), but I would like to present you with a written statement.

I have done much research on this topic (I have been a professor of economics at Indiana University of Pennsylvania, Indiana, Pa. 15705 for 23 years) and I have something new to add to this debate.

Sincerely,

Steven Cord

Steven Cord

Summary: if the government collected the locational value of land (annual rent), it would alleviate many economic problems.

Re deficit: if this were done, taxes on producers could actually be reduced and the economy would actually experience a resurgeance.

Re enterprise zones: if they are successful, then land values in them go up, which is a deterrent to further economic growth Govt. land rent collection would counter that deterrent.

Tax land not production.

April-May 1993

Incentive Taxation

SPECIAL ISSUE
CLINTON & DEFICIT

Our Annual U.S. Federal DEFICIT Issue

We intend to come out annually with a Special Issue devoted to the U.S. Deficit, but one of our readers convinced us that this year we should focus more on President Clinton's economic plan, which happens to be very deficit-oriented. Of course, we'll continue to maintain our non-partisanship.

What He Proposed

(A) For FY 1994, Clinton wants $16 billion in net extra federal spending, and $60.4 billion in net extra taxes.[1] The current deficit is running about $325 billion a year, not counting off-budget federal debt-guarantees and the already-pledged social-security surplus.[2] By 1998, Clinton projects an annual deficit of about $240 billion.[3]

(B) For 1994-97, he proposes to reduce some expenditures: e.g., defense (by $76 b.), interest costs, agricultural subsidies to rich farmers, etc., but other expenditures would be increased — job training, college-student loans, national service, community development banks, etc.[4]

(C) He proposes to reduce some taxes: business would get an investment tax credit, individuals would get an expanded earned income tax credit, enterprise zones would get tax reductions, also real estate (!), etc.

(D) Other taxes would be increased: a 36% income tax bracket would be added (but high corporate executives would be exempted if compensation is tied to performance), a new energy tax ("like imposing OPEC on ourselves"), increased corporate tax rate, increased user-fees, etc.[5]

Early polls show broad public support for his proposals, before the new proposed taxes sink in and Congress and the special interests start to oppose the changes in expenditures and taxes. Certainly, his rhetoric and presentation was attractive[6]:

"The test of our program cannot simply be: what's in it for me? The question must be: what's in it for us?

"Unless we reduce the deficit, increase investment and raise productivity so we can generate jobs, we will condemn our children and our children's children to a lesser life and a diminished destiny."

[To Republicans] "All those who say we should cut more, be specific as I have been."

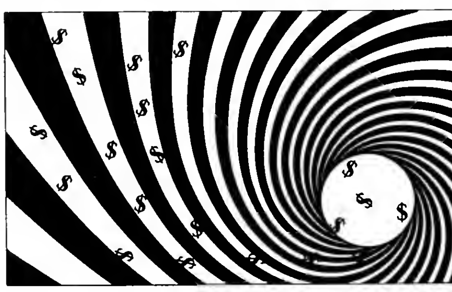
The Effect on the Economy

The future is not for us to see, but we can speculate how the economy will be affected:

• When Mrs. Clinton's health team makes proposals in May, the Deficit can be expected to rise significantly, unless new taxes will be levied.

• It would seem the jobs program is too small to have much impact (the cost is 1/2% of GDP); besides, any economic stimulus will kick in no sooner than 1995 or 1996, at which time the economy might require entirely different treatment.

• Congress and the special interests are likely to oppose Clinton's plan, if history is any guide: every president since FDR has tried to reduce the federal payroll (which now has more civilian workers than manufacturing!), but to no avail.[7] From



continued from page 1

1950 to 1989, the federal government spent $1.59 for every tax dollar.[8] In 1990, Bush agreed to tax hikes and spending cuts; the tax hikes stuck; the spending cuts didn't.[9] David Stockman, Reagan's O.M.B. director, had the same experience in 1982.[10]

• New taxes are likely to slow economic growth: so concludes an empirical study by the prestigious National Bureau of Economic Research.[11] Canada, Germany and Japan also found this out; Hoover and Johnson ditto.[12]

• Higher taxes on producers are likely to yield less revenue, not more.[13] That would increase the Deficit.

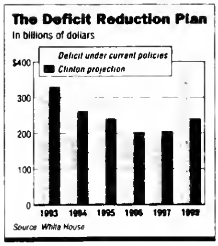
• The Deficit will go up like a Roman candle if the government's Pension Benefit Guarantee Corporation has to spend taxpayer money to insure some bankrupt corporate pension plans, as seems likely.[14]

• If the current weak recession sputters to a halt, then tax receipts go way down and the Deficit goes up. So far, consumer spending has fueled the recession recovery, but experts think this can't go on for long because it grew at a 4% rate in the last six months, whereas after-tax income increased only 2%.[15]

The ONLY Way Out

There is only one way to solve the Deficit Crisis. If we don't choose it, the free economy will self-destruct, and don't bet on democracy and civilization thereafter (!). Socialism the world over has already self-destructed, but in the West it will take somewhat longer because here we have *creeping* socialism via taxation and private land-renting.

We must quickly free producers — workers and businesses — from taxation. The government must tax the annual location value (rent) of land instead.



• The more we burden business with taxes to solve the burgeoning Deficit, the more we kill private enterprise. That creates poverty and unemployment, for which more government expenditures are needed, and higher goes the Deficit.

• The more we tax consumers, the less they have to buy what private business produces. The economy suffers.

• But the more we tax the rental value of land, the more efficiently must land-sites be used; an inadequate inefficient improvement will not produce enough income to pay for the higher land-rent tax.

If we allow landowners to appropriate the income which the government should get, thereby forcing the government to levy taxes on producers, then the sanctity of private property is violated and crime becomes rampant, thus booming government expenditures and the Deficit ....

Maybe if the Deficit gets bad enough, and we get desperate enough, we'll start taxing the locational value of land rather than much-needed production. Only this can save our economy.

• "The future ain't what it used to be."
(Yogi Berra, philosopher)

Sources

Every assertion in this article is fully substantiated. If the following footnotes are printed in small type, that in no way belies their importance in allowing a reader to fully evaluate the substantiation:

1. *Wall Street Journal*, 2/18/93, p. 11, also tax burden chart on p. 10.
2. WSJ, 2/18/93, deficit chart on p. 10.
3. *Ibid*
4. WSJ, 2/18/93, p. 11.
5. WSJ, 2/19/93, p. 8
6. WSJ, 2/18/93, p. 1.
7. *Investor's Business Daily*, 2//19/93, p. 2
8. *Ibid*
9. *Ibid*
10. *Ibid*, p. 2
11. WSJ, 2/18/93, p. 18, article by Alan Reynolds
12. *Ibid*
13. WSJ, 2/18/93, p. 19, article by Kevin Phillips.
14. Martin Mayer, "Pensions. The Naked Truth," *Modern Maturity*, 2/3/93, p. 40ff
15. *U.S. News & World Report*, 2/22/93, p. 43.

New York Times (editorial 1/8/87 "A Sensible Way to Sell the Air"): "You can't see or touch the telecommunications spectrum. Yet the space on the dial is a valuable Federal resource. The Administration, which had been ready to give away unallocated frequencies, now wisely proposes auctioning them. That could bring in $600 million next year. As important, the switch to an auction system would assure efficient use of the resource."

INCENTIVE TAXATION

CSE

This bulletin is published by the Center for the Study of Economics, 2000 Century Plaza, Suite 238, Columbia, MD 21044, (410) 740-1177, FAX 1-410-740-3279. Editor: Steven B. Cord. Inquiries invited. Subscription rate $12/year. ©

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1921

THERE IS A WAY OUT

DEFICIT REDUCTION - If taxes on producers (workers and businesses) are increased to pay for the deficit, it can throw the economy into serious recession - unless a tax is levied on land values, in which case all sites will have to be used efficiently, thereby creating jobs (using a site inefficiently will be penalized because there'll be too much land value tax covered by too little income from an inadequate improvement). Only a tax which actually creates jobs will get the federal government out of its deficit hole.

Yes, the federal government can levy a land value tax. This is authorized by the 16th Amendment and the federal government levied such a tax even prior to that amendment, in 1798, 1811 and 1861. We have studied such a tax for forty years and can provide factual substantiation and how-to-do-it details upon request.

In short, tax the locational value of land, not production. Doesn't that make sense?

ENTERPRISE ZONES - If they work, then land values inside them will skyrocket, making further E.Z. investment uneconomic. The solution is to encourage localities to raise the tax rate on land values. That'll keep land values down and help investors. We would be glad to provide how-to-do-it details.

Steven Cord

Steven Cord, President
C.S.E.

TESTIMONY OF GERALD J. ROPER
CHICAGO CONVENTION & TOURISM BUREAU

CHICAGO

Chicago Convention and Tourism Bureau, Inc.

Chairman Rostenkowski:

Thank you for inviting us to submit our testimony into the record to voice our opposition to the meal and entertainment deduction from 80% - 50%.

This administration is facing many tough decisions, but a no vote regarding this reduction can be a sizable factor in reducing further layoffs. For example, Chicago, this country's leading convention and trade show destination, will be hit hard if each of our 18,000 restaurants lays off just one employee as a result of this deductibility reduction. That downsizing translates into 18,000 individuals out of work.

It has often been said, "When we shoot at the big guys, it is the little people who get hit." The convention and tradeshow industry had an economic impact of $57 billion dollars on U.S. cities in 1991. This particular industry has been one of this country's true growth industries. We ask you not to impede that growth.

For the following reasons, I strongly oppose any further reduction of the deductibility on business meals and entertainment:

- To assess the additional impact of the proposed reduction now under consideration, the National Restaurant Association researched potential job loss and determined an estimated additional 165,000 jobs would be lost in foodservice establishments with business meal clients.

- The range of business activities that will be regulated by Section 274 of the Internal Revenue Code goes far beyond reduction of deductibility of business meals and entertainment. The reduction from 80% to 50% deductibility also would include:

- Business traveler's own meals even in a hotel coffee shop
- Refreshments served by companies in convention hotel rooms (hospitality suites) where they are displaying products or services in conjunction with a trade show
- Banquets and receptions held as part of a convention or trade show
- Continental breakfasts prior to a meeting, coffee-breaks and working lunches

o Cities across the country have convention and visitor bureaus to serve as their destination marketing arms. Their ability to generate a positive impact for the cities they represent will be seriously impaired if deductibility is pared even further.

o If deductibility is lowered from 80% to 50%, invididual business travelers will cut back on the number of trips they take. Attendees at conventions will shrink. Event sponsors will decline to use banquets, receptions and hospitality suites as part of their marketing efforts, directly impacting food service facilities and their remaining employees.

We can go on, but the bottom line is that if there is a cut in the deductibility for meals and entertainment, that will affect the livelihood of hundreds and thousands of citizens.

Again, thank you for allowing us to convey our thoughts regarding the meal and entertainment deductions.

TESTIMONY OF STEVEN L. HAYES
Citizens for an Alternative Tax System

Citizens for an Alternative Tax System very much appreciates the opportunity to provide this written testimony to the House Committee on Ways & Means regarding the Committee's hearings on President Clinton's economic plan. There has been much attention focused on deficit reduction throughout the Presidential campaign. We believe that we must have a tax policy that is conducive to a growing, healthy economy if we are to achieve deficit reduction within the next decade and still maintain essential government services.

Many Americans criticize the amount the federal government spends as being too excessive, but few dispute that our government does provide some needed services and that these services require a substantial amount of revenue. Throughout history, civilizations that flourished had a tax system that created the revenue necessary to fund the government without unduly burdening the economy and its citizens - the ultimate producers of all revenue. While not the only cause, many once-great nations have decayed when their tax systems grew to be burdensome and were perceived to be unfair.

Citizens for an Alternative Tax System is a nationwide grass roots public interest group working to educate the American people about the inherent flaws of our income tax system. We believe that America needs a tax system that has the ability to generate the necessary revenues to fund government at a reasonable level of service, and one that is not only <u>not</u> a drain on the economy, but perhaps even more importantly, is perceived to be fair. We believe that the system of taxation our country should immediately adopt is a national retail sales tax to completely replace the income tax.

Since our organization was formed in 1990, our spokespersons have made over 3,000 radio and TV appearances around the country, and we have grown to over 400 chapters nationwide. Our supporters can be found at all points of the political spectrum, but all agree that replacing the income tax with a national retail sales tax ("NST") is vital to reviving our nation's economy. Members of our organization share the belief that a tax system which has the least negative effect on the economy, is understood by its citizens and is perceived to be fair is necessary if we are going to remain an economic superpower. It is our belief that the correct tax system will be one that is:

- Simple, fair and easily administered;
- Able to collect far more than it costs;
- Not perceived as regressive;
- Conducive to increases in productivity and savings;
- Strengthening U.S. competitiveness in a global economy;
- Assuring that the underground economy pays its fair share of taxes;
- Providing economic incentives to work and produce;
- Not violative of the privacy rights of citizens;
- Contributing to the reduction of the deficit.

As will be set forth in detail, the NST achieves these objectives, and more. The NST is a simple retail sales tax, with no exemptions, applied to all retail goods and services. The NST will raise more revenues than those raised by the present income tax because it will stimulate, not hinder, the economy.

Many people confuse the NST with a value-added tax ("VAT"). The NST is not a VAT. A VAT is similar only in the fact that it is a tax on consumption instead of income, but the similarity ends there. A VAT is applied to the cost of production of goods at each stage of production by adding a percentage to the value added by each manufacturer along the chain of production. Studies show that the tax burden of a VAT on the final consumer is virtually the same as that of the NST. However, the VAT is hidden in the cost of products and is incredibly complex. The NST is simple - a flat rate applied to all retail consumption, and obvious - when you go to a store and make a

purchase, the sales tax is clearly shown separately on the receipt. The national sales tax is not the same as a VAT and should not be equated with a VAT.

What NST rate would be needed to replace the revenue currently generated by the income tax? Dr. John Qualls, president of Micro Economics, Ltd. and adjunct Professor of Economics and International Affairs at Washington University in St. Louis, Missouri, prepared an economic study using the COREMOD policy simulation model to delineate the economic effects of replacing the income tax with the NST. (Results of this study were presented in earlier testimony to this Committee in July, 1991.) Dr. Qualls found that a 16.3% NST rate was needed to replace the income tax collections of $587 billion in 1990, given a consumer spending level of $3.605 trillion in that year.

However, before we begin our analysis of the present income tax system and compare it to the NST, it is useful to set out the history of taxation in the United States.

During the period from 1776 through 1862, the United States funded its federal government through a system of duties, tariffs and excise taxes. The U.S. income tax had its beginnings during the Civil War when President Lincoln, desperate for revenue to finance his efforts to preserve the Union, initiated an income tax. When the war was over, Congress actually eliminated this tax along with others, as the additional revenues were no longer needed. It reappeared briefly in 1894 but was found to be unconstitutional by the Supreme Court. In 1913, the Sixteenth Amendment was passed and enabled Congress to levy an income tax. During the Congressional debate on the Sixteenth Amendment, a proposal was advanced to put a constitutional cap on the income tax rate of 10%, but the proposal was reportedly laughed off the floor of the House. It was believed that Americans would never stand for an income tax rate as high as 10%.

However, the impact of the income tax of that time was very different from that of the present income tax. Rates began at one percent of incomes from $3,000 to $20,000 and progressively increased thereafter. Only one out of every 271 Americans was wealthy enough to pay the tax, so it became a sort of status symbol. As late as 1950, the average American family paid only two percent of its income to the federal government in the form of income and employment taxes. By 1990, that rate had risen to 24 percent, and is continuing its upward spiral to this day.

As an aside, a heavy progressive or graduated income tax is the second point of Karl Marx's 10-point revolutionary program. The Soviet Union, after seventy some-odd years of the application of these points, is no more.

We will examine each of the previously listed objectives of a correct tax policy, comparing the present status quo of the income tax with the results that could be achieved by the NST.

Simplicity, Fairness and Easy Administration

Whether it's a blue collar worker or a millionaire, the present income tax system is not considered fair by Americans today. Some point to the ability of the rich to manipulate the income tax system while others merely have an intuitive sense that not everyone is paying their fair share.

Let's examine some of the reasons for this perception. The income tax is famous (or infamous) for its complexity and incomprehensibility. The U.S. income tax code is more than 2,000 pages with 10,000 pages of regulations and over 200,000 pages of IRS and court interpretations. The Tax Reform Act of 1986, touted as a great move toward simplification, actually added 1500 pages to the code and whole new layers of complexity.

Representative Clay Shaw (R-FL), a senior member of the House Ways & Means Committee, was recently quoted as stating, "I'm a CPA and a lawyer, and I got the highest grade in taxation at law school, yet I don't prepare my own return." A recent survey done by *Money* magazine revealed that 34 of the 58 Senators and Representatives on Congress' two tax-writing committees don't prepare their own income tax returns.

It is estimated that nearly 50% of taxpayers hire professional assistance to prepare their returns. However, this is no assurance of their accuracy. *Money* magazine has also sponsored surveys where 50 professional tax preparers and accounting firms are furnished with facts relating to a hypothetical

family and their tax return and asked to prepare the return. In 1990, only one preparer came up with the hypothetical right answer. In 1991, no one got it right. In both years only five preparers came within 10% of the hypothetical right answer, and there was a spread of over $60,000 between the lowest and highest taxes calculated.

These examples and the experiences of our citizens have led to the widely-held belief that the tax system is incomprehensible and unfair. Even if a taxpayer endeavors to honestly and diligently comply with the law, there is no assurance that the tax return will be correct and not subject to audits and penalties. This is unconscionable in a free society.

How would the NST be different? First, 45 of the 50 states presently collect retail sales taxes. Both those who will be collecting the NST and American citizens are familiar with a retail sales tax. For most citizens it will require no recordkeeping or filing of tax returns. This alone will reduce the complexity of the system because it is estimated that there will only be ten million businesses who collect the NST and thus will be required to file tax returns. This is contrasted with the nearly 120 million tax returns now filed under the income tax by both individuals and businesses.

Second, with no exemptions it will be a fair tax because everyone will pay the same rate on their purchases.

Third, for the businesses collecting the tax, reporting duties will be vastly simplified. The tax calculation is limited to multiplying the amount of sales and/or services by the NST rate.

Fourth, the amount of taxes paid to the federal government will no longer be hidden from the American people. The federal taxes will be added to the cost of their purchases and will be clear to all, instead of being directly withheld from their paychecks.

Collecting Far More Than It Costs

Aside from its complexity, the present income tax system costs the American economy an enormous amount of money each year. As an IRS-sponsored study showed, Americans spend in excess of six billion hours a year merely filling out tax forms; therefore, the true cost of the income tax system is in addition to the $5 billion dollar budget of the IRS. James Payne has done an excellent, thorough analysis of the cost of the income tax system to the American economy. He estimates that the total cost of operating and complying with the income tax laws in 1990 was $618 billion, or 65% of total tax revenues to the government. The corporate income tax amounts to roughly $100 billion in tax revenues per year, and Mr. Payne estimates the cost of compliance for it alone is at least $100 billion per year and likely even higher. His analysis included only costs that could be reasonably measured or estimated. Some experts even go so far as to say that the total cost to the economy is as high as $1 trillion per year. It is doubtful that a more inefficient and wasteful system of collecting revenue could be found.

This is why many economists believe that a significant cost of the income tax system is the misallocation of vast numbers of our citizens to an essentially non-productive area. Not only will removing the income tax free up an enormous amount of time for more productive uses, but it will also allow a vast number of workers to move to more productive careers. Tax accountants, tax attorneys, and all the other employees in the myriad industries that have grown up around the income tax system will be able to devote their energies and intelligence to helping American business become more efficient and competitive.

Another substantial cost to the economy arises from the distortions caused by the income tax code. How many purchases or decisions are made because of the income tax consequences and not because of the practical realities of the situation?

Some are concerned about the loss of jobs that this change in the tax system would create. However, throughout our history out-dated industries have been replaced with newer industries and American workers have adapted to the changing work environment. Americans understand that reducing the defense budget will require many defense workers to obtain jobs in other areas. However, no sane American wants to have a renewal of the Cold War simply because it will preserve some jobs in the defense industry.

How would the NST correct this problem? The national sales tax collection system could be piggybacked onto the state sales tax agencies, who would then remit the collections to the federal government. Alternatively, the IRS could do the job, but with much less of a bureaucracy. Instead of thousands of pages of tax code, regulations and court cases, the sales tax law would ideally be less than 100 pages.

Since the only taxpayers will be either sellers of retail services or retail goods, the job of the tax collectors will only be to ensure that the full amount of sales are reported and that this amount is multiplied by the NST rate. No longer will employees of the taxing agency have to attempt to apply an incomprehensible code to every aspect of an individual or business.

The Issue of Regressivity

Commonly, tax systems are evaluated based on whether they are perceived to be regressive or progressive. Sales taxes are often labeled as regressive because a lower-income worker typically spends all of his income on consumption. This means that all of his income is taxed under a sales tax. The higher-income worker may not have to spend all of his income on consumption and, therefore, will not have all of his income subject to the sales tax. In fact, even though it is widely agreed that the income tax penalizes productivity, savings and is extremely costly and difficult to collect, the income tax is defended because it is said to be progressive.

However, is the income tax really progressive? In addition to the income taxes we must pay on April 15th each year, the income tax system increases the price of goods and services we purchase by between 10% and 30%. The income tax is a cost of doing business; in order to stay in business, companies must pass on that cost in the form of higher prices to the consumer. These higher prices include not just the income taxes of the business producing the final product but also the tax costs of all of the people who supplied goods or services to the business and the tax costs of all of the people who supplied goods and services to the suppliers. This problem is exacerbated even more because a business seeking a $1.00 profit has to raise its prices not by $1.00 but by an amount between $1.20 and $1.60, because it has to earn enough money to pay the income tax on the profit and still have $1.00 remaining.

Another reason that the income tax is thought by many to be progressive is that they don't realize how much money it costs to make non-business expenditures. Take the example of an individual who purchases a $10,000 car. Most people see a price of $10,000 and assume that it only costs them $10,000. Under the income tax, the individual must earn anywhere from $11,700 to $14,500 of pre-tax income, pay anywhere from $1,700 to $4,500 of income tax, and net $10,000. Under a national sales tax of 16%, the tax would be $1,600. Period. The income tax actually penalizes consumption more than does the NST.

Is the NST regressive? Studies have shown that a consumption tax is not regressive or progressive, but is proportional with respect to long-term income. Most people spend the money they earn during their lifetimes, although in some years consumption will not equal income. This will balance out over time because the consumption of most households roughly equals their lifetime income.

Yet, despite all of its advantages, the imposition of the NST will not be an immediate boon for all Americans. Our country has been operating under the income tax for 80 years. For lower-income and fixed-income individuals, the NST could present a hardship at the initial outset of replacing the income tax with the NST. Some argue that the only way the NST can protect those Americans on fixed incomes or lower incomes is to exempt large classes of consumer goods such as food, clothing, medical care and shelter. By exempting these classes of consumer goods the rate of the NST would no longer be 16% but would have to be increased to over 22%.

Does exempting food, medical care and shelter accomplish the desired result in the most efficient way? We don't believe it does for several reasons. First, the amount spent on food, shelter and medical care by a family earning $20,000 per year is very different from the amount spent by a family earning $100,000 per year. The higher-income family will not only spend more but it will purchase more expensive items than the other family. Therefore, much of the benefit gained from exempting classes of consumer goods is enjoyed by the income groups that need it least.

Second, when you create an exemption, then everyone will try to ensure that their product is a part of the exempt category. This will create unnecessary complexity.

The solution is simple. We believe that any hardship from the imposition of the NST can be handled by means of cash rebates from the federal government of $50 per person per month, regardless of income level. Translated, this means that a family of four would essentially pay no NST on the first $15,000 of retail purchases per year, roughly the equivalent of the standard deduction and the personal exemptions currently allowed by the present income tax system.

Productivity and Savings Growth

How does the income tax affect productivity in the U.S.? The U.S. economy grew steadily from the end of World War II until the early 1970's when it began to slow down, and it has been declining ever since. Several indices that illustrate this are:

1. The average weekly wage of workers (in inflation-adjusted dollars) in the private sector rose from $196 in 1947 to $315 in 1973, where it peaked. By 1990, that average had fallen to $258, wiping out one-half of the progress U.S. workers had made since World War II.

2. U.S. productivity increased at an average of 3.2% per year between 1960 and 1973, an average of 2.2% between 1973 and 1985, but only increased 0.9% a year between 1979 and 1985.

3. GNP growth averaged 45% during the 1960's, less during the 1970's, and worse yet during the 1980's at 30%. This is lower than any other decade since the Depression.

4. Americans now save only about 5.6% of their disposable income, the Japanese save 15.3% and the Germans 12.2.%. Savings in the U.S. represents only 15.1% of gross domestic product while savings in Japan accounts for 33% of its GDP.

Recent announcements of productivity increases in 1993 can only be attributed in part to real productivity growth. These announced productivity gains use U.S. dollars to compare the payments to workers in different countries and, thus, is due not to an increase in real productivity but due to a decline in the value of the dollar.

Why is productivity important to America? Dr. John Qualls calculated that if the rate of productivity had continued at the same rate in the 1970's and 1980's as it was from the 1960's to 1973, we would be in a much different America today. At current levels of spending, there would not be a budget deficit and the average family would have $10,000 more each year in real disposable income.

Does the income tax encourage productivity? We believe the answer is resoundingly no. First, not only does the income tax require millions of Americans to spend billions of hours not producing anything that benefits society, but it also acts as a penalty on productivity. The more you produce the more tax that you pay.

Second, the income tax penalizes savings and investments. The rate a nation saves is directly correlated with its rate of economic growth and the health of its economy. The more a country saves the less the cost of investment capital and the greater the supply. The U.S. has had the lowest personal savings rate of any of the industrialized nations over the last 17 years. Our citizens are taxed when they earn their income and then, if they manage to save some of their after-tax income, are taxed again. When you subtract the costs of the income tax and inflation from the interest earned, many Americans actually lose purchasing power when they choose to save and invest.

In addition, in order to fund our escalating budget deficit, many Americans and American banks and savings and loans have elected not to invest in American business but to invest in U.S. debt instruments. This has dramatically reduced the availability of investment capital for most small American businesses even though the "stated" interest rate is very low. It doesn't matter what the

interest rate is to the small businessman who finds that no one will loan him money because the limited amount of capital is either going to finance government debt or to Fortune 500 companies.

How does this lack of availability of capital directly affect productivity in our global marketplace? In order to become more productive many American businesses must obtain modern equipment and facilities. The Office of Technology Assessment estimated that each year from 1977 to 1988 the cost of capital in America averaged 3.4% higher than the cost of capital in Japan for investments in machinery and equipment with a physical life of 20 years, 4.9% higher for a factory with a physical life of 40 years and 8% higher for a research and development project with a 10-year payoff. It is not merely a coincidence that countries with higher savings rates have higher rates of sustained productivity growth.

How would productivity be affected under the NST? First, under the NST productivity would not be penalized. The more you produce and earn, the more you can keep.

Second, under the NST the segment of our population now required to perform non-productive work to attempt to comply with the income tax will be available for productive activities. To illustrate, most knowledgeable observers agree that corporations spend between $90 billion and $100 billion in attempting to comply with the income tax. How much more competitive would American corporations be if they could reallocate this $90 billion to activities that would allow them to be more competitive? With this capital they could modernize plants and equipment and retrain employees, creating more jobs and greatly enhancing their efficiency.

Third, Dr. Qualls' study illustrated some of the effects of replacing the income tax with the NST. In general, changing to the NST produced faster economic growth and higher productivity. GNP grew at a faster rate without the burden of the income tax.

Fourth, Dr. Qualls' study showed a reallocation of GNP away from consumption and toward investment. The investment share of GNP rises from 17.1% to 19.1% under the NST, and real business investment is from 19% to 25% higher. In effect, businesses use the extra cash flow resulting from the elimination of the income tax to invest in plant and equipment.

Fifth, Dr. Qualls' study showed that the higher level of capital stock results in more job creation. By the year 2010, under the NST more than 1,600,000 new jobs will be created than would be created under the present income tax. More earnings by employees in the private sector fuels more consumer spending. So consumer spending rises from its current level, but it actually declines as a percentage of GNP - from 63% to 61%.

Sixth, Dr. Qualls' study showed that the NST is <u>not</u> inflationary. Although the price of goods would reflect a one-time price increase due to the tax, the rate of increase in prices after that time would actually be lower by 0.2% per year. Thus, sustained inflation would drop after introduction of the national sales tax and abolishment of the income tax.

Seventh, Dr. Qualls' study found that with the NST the private savings rate (both personal and business savings) rises from 15.4% to 18.1%. Under the income tax, money is put into savings with after-tax dollars, dollars that are becoming increasingly scarce for many American families. Under the NST, the amount of tax a person pays is controlled by a person's spending. The choice can be made to save and not spend, and thus avoid paying any tax. As we have seen, this does not mean that consumer spending dries up; on the contrary, the total dollars spent actually increases.

Keeping Up in the Global Marketplace

How does the income tax affect our ability to compete in the global marketplace? In order to fund their governments, our major trading partners around the world rely heavily on consumption taxes. These taxes are applied to all products sold in their countries, whether domestically made or imported, and are "border-adjustable," meaning that they are rebated to manufacturers within the country on their products that are exported.

Congressman Sam Gibbons of Florida has stated that our income tax system has caused us to be a nation of exporters, but that we are exporting the wrong thing. High-paying American jobs are vanishing overseas at an alarming rate. We lack a border-adjustable tax which allows the

consumption taxes on exports to be rebated at the border. Therefore, we handicap our manufacturers whose goods all bear the cost of our government when they are exported. We are penalizing American products and subsidizing imports.

To illustrate the inequity, assume that an American-made product and an identical foreign-made product each have a selling price of $1.00. Both products have as a component of that price built-in tax increases of approximately 20% (in the U.S. this 20% is due to income taxes; in countries such as European Common Market countries the increase is usually due to consumption taxes), or $0.20.

When the foreign-made product is exported to the U.S., the consumption taxes are rebated back to the foreign manufacturer as the product crosses the border. It thus arrives in the U.S. at a net cost of $.80 and the U.S., for all practical purposes, does not require the product to pay any income tax. Former Congressman Richard Schulze stated that in 1989, the $600 billion of imports that year paid an income tax of only 0.1%. This product with a cost of $0.80 competes against U.S.-made products costing $1.00. Further inequities occur when the U.S. product is exported to a foreign country. U.S. manufacturers receive no rebate of the income tax component of the cost, and to compound the problem, the foreign country will tack on their consumption tax (say an average of 20%) to the cost of the good. So the $1.00 exported item now costs $1.20 and is competing against similar foreign products at $1.00.

How would this be different under the NST? With the NST, the U.S. will have a border-adjustable tax. U.S. products will be on an equal footing in terms of bearing the cost of government with foreign-made products from around the world. Under the General Agreement of Tariffs and Trade ("GATT"), our exports will no longer be forced to contain the cost of the U.S. government and the cost of the foreign country's government, or up to an additional 40% of the cost, as they do now. No longer will importers be allowed to use various accounting procedures to escape paying their fair share of American taxes.

Our companies will no longer be forced to locate factories in other countries in order to compete in a global economy. More higher-paying jobs, that would have otherwise gone to foreign citizens in their countries, will now go to Americans in our country. With the NST, we will no longer be exporting jobs to foreign countries, but products and services as we should be.

How to Capture the Underground Market

Americans will pay a fair tax. The vast majority of Americans wish to support their country and do not advocate criminal avoidance of taxes. Because the present income tax is increasingly viewed as being anything but fair, the underground economy is rapidly growing.

Former IRS Commissioner Fred Goldberg has estimated that $127 billion of taxes were not collected in 1992 due to the underground economy. Some feel that estimate is too conservative and a figure of $200 billion is closer to the truth. This encompasses not only illegal sources of income, such as drug dealing, gambling and prostitution, but also the average ordinary citizen who accepts a lower price for cash payments and doesn't report the income, or the businessman who keeps two sets of books and pockets a portion of the sales. Tax protestors are on the increase - people who are fed up with the system and are willing to do anything, including paying several thousand dollars to be "un-taxed" and risking a prison sentence, or just dropping out of the system.

What do the minister who decides to pay cash to have his roof repaired because it is 25% cheaper than if he pays by check, the worker who has a second job delivering furniture on weekends and is paid in cash, and the drug dealer who does not report his illicit profits all have in common? Under the Internal Revenue Code they are committing criminal acts, and are all members of the "underground economy" to some degree.

How would this change under the NST? First, the burden of accounting for and paying federal income taxes will not be placed on the average citizen. April 15 will be just another day and we will no longer be required to perform what has been called "slave" labor compiling information for income tax returns. The NST will eliminate over 100 million individual taxpayers, with only approximately 10 million business and corporate entities remaining as taxpayers.

Drug dealers and people who refuse to file income tax returns or report all of their income still have to make consumption purchases. The NST ensures that even drug dealers pay their fair share when they buy their automobiles, yachts, televisions, etc. There will be an element of noncompliance under any tax system, but the NST will be much harder to illegally avoid.

Restoring the Incentive to Work

Our country was long viewed as a land of opportunity by many who lived in less fortunate countries than ours. The ability to work and earn a living, or start one's own business, is looked upon as very desirable. The incentive to work and better one's own condition is a strong force in driving new business formation and new technology.

How has the income tax affected those who have a job or their own business? In the 1980's more than 90% of the 18 million new jobs created were created by small and new businesses. Higher and higher effective tax rates that penalize those who earn a decent living and tend to discourage people from working harder. Any extra hours worked means that an even higher percentage of the income earned will have to be paid back in taxes. More and more people are opting for increased leisure time and less productivity. Small business owners have an even tougher time under the present income tax laws and other regulatory nightmares the government has seen fit to impose on them.

Throughout most of our history, the income tax either didn't exist or didn't apply to most of our citizens, and Americans have historically been able to work and provide for their families and not have to depend on handouts from the federal government or any other government. Americans want a government that will assist those in need; but without a growing economy, one in which jobs are readily available for all those who want one, the government is going to be unable to generate the revenues to fund their social programs.

What you tax, you discourage or penalize. By taxing income, we are in effect taxing production. Thus, we are penalizing or discouraging individuals from working and from new job creation. Professor Richard Vedder of Ohio University, in a study performed for the State of California, addressed the budget crisis in California several years ago and attempted to identify the type of fiscal policy that would minimize the damage, or maximize the benefits, to the California economy. His conclusion was that a tax on income has a dampening effect on an economy, whereas a sales tax has a neutral effect on an economy.

What effect would the NST have on the work incentive? First, the individual has greatly expanded incentives to work and produce. He can keep all of the money he earns and if he decides to save some if it, he will not be penalized by being taxed on first his earnings and then his savings. The rich will pay their fair share as they tend to spend more. If they don't spend more, they save or invest and thus help to fuel the economy by increasing the availability of capital and decreasing its cost. Small business owners can spend less time on non-productive government paperwork and more time on making their businesses successful.

The IRS - Servant or Master?

The IRS admits that substantial voluntary compliance with the federal income tax is a thing of the past. It is cruelly ironic that the IRS believes that the only way it can collect the amount of tax demanded by Congress is to become more and more like the national police forces so abhorred by German citizens in the 1930's and by the Russian people until recently.

The incomprehensibility and sheer complexity of our income tax laws often defy even the understanding of the agency set to enforce those laws. The income tax of today requires the IRS to pry into virtually every aspect of our private lives and finances. The IRS has the ability to summons nearly every financial record for an individual without their consent or even their knowledge. Taxpayers are presumed to be "guilty" until they can prove their "innocence". This attitude simply increases the confrontational aspects of encounters between the IRS and the American taxpayer and makes the job of the IRS even more difficult.

A growing number of Americans believe that the purpose of a taxing system should be to fund necessary government functions at a minimum of cost to the economy, and not to provide a covert means for gathering data on and controlling every citizen.

What impact will the NST have on the IRS and their mode of operation? If in fact the IRS is used to collect the NST many positive changes will occur. Many IRS agents with whom we have spoken would welcome the NST. The NST is completely a "pay-as-you-go" system for the average person and doesn't require tax returns to be filed with the government. There is no need for the IRS to analyze shoeboxes full of receipts and spend countless hours examining income tax returns. No longer will IRS agents be locked in battles with their fellow citizens over "interpretations" of an income tax code that neither understands. The IRS will merely seek to ensure that the taxpaying businesses have reported all of their sales and have paid the required NST rate.

Deficit Reduction in the 1990's

In a recent article in *THE WALL STREET JOURNAL*, W. Kurt Hauser points out that over the past 44 years there have been 25 substantive changes in the federal tax code, with the top marginal personal income tax rate ranging as high as 92% and as low as 28%. However, despite the changes in tax rates during these 44 years, federal government revenues have averaged about 19.5% of GDP. Even after the Economic Recovery Tax Act of 1981, the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1990, revenues as a percentage of GDP in the two years prior to the tax acts were not meaningfully different from those in the two years following.

There is no reason to believe that this pattern will be different in the future. The tax revenues received by the federal government will, in all likelihood, not vary greatly as a percentage of GDP in future years regardless of the changes in the income tax codes. To generate the increased revenues necessary to fund the social programs that the American people want and also eliminate the deficit, we must institute a tax policy that will stimulate the growth of our GDP in a much greater manner than the income tax. As the GDP increases, the tax revenues to the federal government will increase. Only in this way will our government receive a rapidly increasing amount of income.

The National Sales Tax - America's Salvation

The national sales tax will make America the number one economic power in the world again. It can give us back a healthy, growing economy by removing a big barrier to increased productivity in that economy. It is simple, fair, and easily administered. It is not regressive but proportional, and it provides incentives for individuals and businesses to work and produce. It captures a large portion of income that is currently going untaxed, both from the underground economy and from goods imported from foreign countries that pay virtually no tax. It is efficient in raising revenue and is not a drain on the economy. It is the only way that will allow the U.S. to retain the social programs we have come to view as entitlements and still eliminate the deficit.

As a historical footnote, a scenario similar to the present one faced by the U.S. existed in England in 1815. England had just finished 20 years of fighting the Napoleonic Wars and had an enormous debt. Parliament ignored the dire warnings of the economic experts of the time and eliminated the income tax which had been initiated to raise revenue to fund the fighting. What followed was a 60-year period of unprecedented growth and prosperity that has come to be known as the Industrial Revolution.

It is time for Congress to have the same courage exhibited by Parliament in 1815 and give our children a prosperous and growing America - not one that is declining and saddled with an enormous debt.

TESTIMONY OF COLLEGE AND UNIVERSITY PERSONNEL ASSOCIATION

The College and University Personnel Association (CUPA) is a non-profit association which represents over 1,600 private and public college and university human resource departments throughout the United States and has an individual membership of more than 5,500 members. Our primary mission is to provide information and leadership to college and university human resource departments. Therefore, CUPA would like to submit the following written statement for the record in support of Section 127 Educational Assistance of the Internal Revenue Code.

As you are aware, Section 127 allows employers to provide up to $5,250 a year in nontaxable reimbursements or direct payments to employees for tuition, fees and books for both undergraduate and graduate courses. Congress has supported Section 127 since it first became law in 1978, mostly through continued one-year extensions of the benefit. Although the 102nd Congress extended Section 127 through July 1, 1992, an additional 18-month extension of Section 127 contained in H.R.11 died when the entire tax bill was vetoed by then-President George Bush on November 4, 1992.

Again this year, Congress recognizes the importance of Section 127 benefits. Representatives Sander Levin (D-MI) and Fred Grandy (R-IA) have introduced H.R.127, which would permanently extend Section 127 for undergraduate and graduate classes. Additionally, President Clinton's economic package includes a permanent as well as a retroactive extension of Section 127 educational assistance.

As an association that represents human resource departments at higher education institutions, CUPA is in a unique position to evaluate the effectiveness and significance of Section 127 benefits, from the perspective of both human resource professionals and the providers of educational instruction.

As human resource professionals, we see the significance of offering these benefits to employees for use in their continuing education. College and universities have a difficult time competing with the private sector for employees in terms of compensation. Our members have found that Section 127 benefits are an effective recruiting method for prospective employees and a key incentive to retaining employees of the institution who might otherwise go to work in the more financially lucrative private sector. Higher education institutions also realize how important the educational assistance is as an investment in human capital. By offering the 127 benefits, the institutions receive in return a better-skilled, better-educated employee. On average, college and university employees who receive benefits under Section 127 are not using the benefits for law degrees and MBAs, but are instead simply trying to improve their basic workforce skills or work towards an undergraduate degree. Many of these employees are in less-skilled and lower-paid positions at the institution and need the added training and skills to qualify for better jobs.

As providers of education, we witness first-hand the usefulness of Section 127 benefits as they are applied by the private sector and their employees to educational pursuits. Private-sector employees can utilize their Section 127 benefits in several ways. First, 127 benefits are used by employees to keep current with changing trends in rapidly advancing fields. This encourages companies in high-tech fields to send their employees, such as engineers and computer programmers, back to school to broaden their skills and knowledge and to keep them abreast of the newest cutting-edge technology and trends. Second, as indicated by a 1988 Department of Labor study, 56% of United States workers have four years of high school education or less. Companies are finding out that many employees entering the workforce in this educational category need remedial training in basic reading, writing or mathematical skills. As the Department of Labor's Workforce 2000 indicated, 80% of today's workers will be working well into the 21st century. It is essential that employees are encouraged to continue their education, not only to benefit their companies but the United States as well. Third, companies are using 127 benefits as a retraining tool for their workforce. Many companies faced with increased economic competition not only from within the United States, but internationally as well, are rapidly retraining their workforce to compete.

As barriers to free trade are eliminated and the European Community becomes a reality, the ability of the United States to compete in a world economy will be increasingly challenged. It is apparent that if the United States is going to meet this economic challenge, American workers

have to continue educating themselves and learning the technological skills necessary to compete in the international arena. Both President Clinton and Secretary of Labor Robert Reich have called for increased spending and investment in training and retraining by employers in their workforce. Members of Congress have joined in this effort by asking the nation to make increased adult education and worker training a priority. Yet the one vehicle that encourages employer investment and assistance toward the goal of providing educational assistance to workers, is not even a permanent section of the Internal Revenue Code. The continued uncertainty in the tax code regarding Section 127 benefits is an impediment to employers who want to provide worker training and educational assistance. It is essential that during this session of Congress, certainty be restored to this area of the tax code by making Section 127 permanent.

CUPA fully appreciates the deficit problems that face this country and the difficult choices which must be made in the budgetary process to determine which programs will be funded and which ones will be eliminated. However, Section 127 Educational Assistance benefits are a prudent and an economically sound investment in the workforce of this country. The result of this investment in "human capital" will be a better educated and more technically skilled worker who will help America's economy to compete internationally. The continued education and development of the U.S. worker are fundamental to meeting the challenges of the international marketplace. CUPA urges Congress to make a sound commitment to the continued education of the U.S. workforce by making Section 127 of the Internal Revenue Code permanent.

CDLA

The Computer Leasing &

Remarketing Association

April 6, 1993

By Hand

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Simpler and Fairer Alternative Minimum Tax Depreciation Rules for Computers

Dear Mr. Chairman:

CDLA, the Computer Leasing and Remarketing Association, submits these comments for the record of the recent Committee hearings on President Clinton's economic plan. CDLA is the nation's largest association of computer leasing companies and its members account for most computer equipment leased and used in the United States.

I. Summary of Position

CDLA believes that the Administration's proposed alternative minimum tax ("AMT") depreciation revisions, while a step in the right direction, critically fail to deal with the current tax disincentive for any business to invest in computers. Moreover, postponing the proposal's effective date until 1994 would actually decrease investment in the short-term and is directly at odds with the Administration's stimulus proposals.

II. The Need for More Appropriate AMT Depreciation Allowances

Virtually all agree that computers and other high technology equipment are critical to America's economic future. The Clinton Administration's technology policy statement concludes that "[t]echnology is the engine of economic growth" and the key to creating a vital, high-wage economy.[1]/

Despite this recognition, the tax depreciation rules governing computers are long outdated and actually discourage investment in computers. Under current depreciation rules, businesses recover their investment in computers over a five year period using the double declining balance method for regular tax purposes. The recovery rate slows to the 150-percent declining balance rate for normal AMT purposes and the straight line method for purposes of the adjusted current earnings ("ACE") AMT adjustment.

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[1]/ See Technology for America's Economic Growth, A New Direction to Build Economic Strength, p. 7 (2/22/93). The Office of Technology Assessment has similarly concluded that "technology is the key to competitive success." See Making Things Better: Competing in Manufacturing, p.1 (OTA-ITE-444, February 1990).

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Mr. Chairman
Page 2
April 6, 1993

The recovery period for computers has remained largely unchanged since they were first recognized as a separate class of depreciable assets in 1973[2]/ and, not surprisingly, fails to reflect the "computer revolution." The appended 1990 study by the Gartner Group concludes that computers were then losing their economic value over no more than 3.4 years or, using a five-year life, at a declining balance rate of 210 percent.[3]/ Moreover, because of industry trends -- the quickening pace of innovation and the increasing preference for smaller computers, which tend to lose value fastest -- the 1990 Gartner Group report almost certainly overstates the economic life of most computers placed in service today.

Because taxpayers must depreciate computers far slower than they actually lose their economic value, the Code not only provides no economic stimulus or preference for computer investment, but also effectively taxes capital invested in, rather than income generated by, computers. This discourages U.S. businesses from making the necessary investments in computer technology and decreases demand for U.S. made computer products, both of which are central to our economic future.

The Administration's proposal to replace the current AMT depreciation allowance with the 120-percent declining balance method is obviously a step in the right direction.[4]/ It is also obviously far too small a step in that direction for computers. The proposal does little to bring the tax depreciation of computers in line with economic reality and thus leaves intact the substantial tax disincentive to make such investments.

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[2]/ See Rev. Proc. 73-2, 1973-1 C.B. 747 (adopting six-year asset guideline period for "information systems"). Prior to 1973, computers were not explicitly described in the depreciation tables, but would have fallen under the general category of "office furniture, fixtures, machines, and equipment", all of which were depreciable over ten years. See id. at 747. In 1981, computers became five-year property under the then newly enacted accelerated cost recovery system and their recovery period has not changed since.

[3]/ Our major economic competitors already permit depreciation of computers in line with the conclusions of the Gartner Group report. As of 1991, Japan, Germany, England, and Canada provided for the recovery of 53.62, 51.00, 43.75, and 40.50 percent of computer costs, respectively, in the first two years of ownership, compared to only 30 percent under the current ACE/AMT adjustment and 33.12 percent under the Administration's proposal. See Ways and Means Committee of the House of Representatives Hearings on U.S. International Competitiveness, July 17, 1991 (statement of Stephen M. Chaleff on behalf of CDLA) (comparison of depreciation allowances prepared by Arthur Andersen & Company).

[4]/ The other aspect of the proposal, under which assets would be depreciated over the same recovery period for AMT and regular tax purposes, would substantially benefit other types of assets, which now use a longer recovery period for AMT purposes. Computers, however, would gain nothing from this change because they already are depreciated over five years for both the regular tax and the AMT. It is ironic that the type of assets that are generally viewed as most important to our economic future would receive the least benefit from the proposal.

Mr. Chairman
Page 3
April 6, 1993

If we are to make the necessary investments in computer technology to compete and succeed in the global marketplace, our tax laws cannot continue to discourage such investments. Accordingly, CDLA urges the adoption of AMT depreciation for computers at a 200 percent declining balance rate over five years (identical to the current normal tax treatment). This would be substantially more consistent with economic reality and our national policy objectives and would still be more conservative than the Gartner Group's findings.[5]/

III. Effective Date

For reasons unexplained, the President's proposed change would only apply to assets placed in service on or after January 1, 1994. This postponement would discourage capital investments until the provision became effective. It was to avoid this result that both the President and Congressional leaders have proposed to make stimulus/investment measures generally effective as of December 3, 1992. Thus, the current date for the AMT proposals is both counterproductive and directly at odds with other aspects of the economic plan. Although the AMT depreciation proposal as applied to computers is not a stimulus measure, it would nevertheless postpone investments unless made effective on the same date as that proposed for the stimulus/investment proposals or some other reasonably current date.

* * * * *

We would welcome the opportunity to answer any question you or your staff may have.

Respectfully,

William H. Sells, III
Director

[The attachments are being retained in Committee files.]

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[5]/ The proposal is also consistent with the Administration's desire to make the research and experimentation credit permanent and, thus, to encourage the pace of technological progress (and obsolesence) for computers and other equipment.

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April 12, 1993

VIA COURIER

The Honorable Dan Rostenkowski, Chairman
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Attn.: Diane Kirkland

Re: Hearing on President Clinton's Proposals for Public Investment and Deficit Reduction -- Statement of the Continental European Insurance Coalition

Dear Mr. Chairman:

The following written statement for the record is submitted by the undersigned as counsel for the Continental European Insurance Coalition on certain tax aspects of President Clinton's Proposals for Public Investment and Deficit Reduction. These proposals have been the subject of hearings before this Committee from March 9 to March 23, 1993. We appreciate this opportunity to record our support for the basic thrust of the President's revenue proposals, including in particular his transfer pricing compliance initiative for international businesses.

The Continental European Insurance Coalition is a group of U.S. insurance and reinsurance subsidiaries and branches of several major continental European-based insurers. Its members have been engaged in business in the United States for decades, in some cases dating back to the nineteenth century. We write coverage for all types of risk, spanning both the life, accident, and health, and the property and casualty ("P&C") segments of the market. We carry out the full range of insurance and reinsurance functions at our U.S. locations, including both underwriting and investment activities. Together we employ over 14,000 Americans throughout the United States in all levels of our business, including virtually all of our executive management. Our annual premium revenues are in excess of $8.5 billion, and we currently have more than $17 billion invested in U.S. assets, including Federal, state, and local government obligations, corporate stocks and bonds, real estate, and other assets.

In short, our members are each established service industry examples of what Secretary of Labor Robert Reich has called "The New American Corporation":

> In an economy of increasing global investment, foreign-owned Corporation B, with its R&D and manufacturing presence in the United States and its reliance on American workers, is far more important to America's economic future than American-owned Corporation A, with its platoons of foreign workers. Corporation A may fly the American flag, but Corporation B invests in Americans.

Harvard Business Review, January/February 1990.

The Honorable Dan Rostenkowski, Chairman
Chief Counsel and Staff Director
Committee on Ways and Means
April 12, 1993
Page 2

As long-standing corporate citizens of the United States, we fully share the Administration's belief that foreign-owned businesses, like U.S.-owned businesses, should pay their "fair share" of taxes in this country. We also recognize the potential difficulties faced by the Internal Revenue Service in ensuring that international businesses do not artificially reduce their U.S. taxable income through manipulation of their related party, cross-border transfer prices for goods and services.

In order to address these concerns, President Clinton proposes an amendment to the Internal Revenue Code section 6662 penalty provisions. Under that amendment, a taxpayer would be potentially subject to a substantial understatement penalty attributable to a section 482 allocation unless the taxpayer could provide contemporaneous documentation demonstrating the application of one or more reasonable transfer pricing methodologies.

We believe that President Clinton's proposal goes right to the heart of the transfer pricing compliance concerns mentioned above. Moreover, it does so in a manner that protects several important principles. First, it preserves the arm's length standard as the exclusive measuring rod for computing U.S. taxable income. Under this proposal, a taxpayer that can demonstrate, through contemporaneous documentation, that its transfer prices were computed in accordance with a reasonable methodology based on the arm's length standard will not be exposed to the substantial understatement penalty. Adherence to the arm's length standard, as opposed to a formulary minimum taxable income requirement (such as that contained in last year's H.R. 5270), is crucial to the avoidance of international double taxation on cross-border businesses.

Second, the President's proposal correctly avoids any improper protectionist slant by applying equally to U.S.-owned and foreign-owned businesses. Nothing could be more fundamental to the continuing confidence necessary to preserve the mutually beneficial flows of cross-border commerce in goods and services than to confirm that the "fair share" of U.S. taxes payable by foreign-owned businesses will indeed be computed in a fair and even-handed manner.

Third, the President's proposal properly focuses on encouraging compliance with, and simplifying administration of, the arm's length standard through documentation requirements that, if interpreted by the IRS in a reasonable fashion, are within the capacity of the taxpayer to satisfy. This aspect of the proposal ensures that its effect will be felt most strongly where it should -- namely by those taxpayers whose current transfer pricing practices are not sufficiently focused on compliance with the arm's length standard.

As this proposal undergoes further consideration in the legislative process, we trust that the lawmakers will be willing to consider a few significant ancillary issues. First, it will be important for taxpayers seeking to comply with the proposal's documentation requirements to have confidence that the transfer pricing "methodology" they intend to document will be accepted as a reasonable one. In this connection, we would simply note that the section 482 regulations relating to transfers of goods provide considerably more guidance on the appropriate transfer pricing methodologies that may be used than do those relating to transfers

of services. Thus, taxpayers engaged in service businesses may be faced more frequently than other taxpayers with the situation where the section 482 regulations do not prescribe any specific pricing methodology. Because of this, taxpayers in service industries should not be required to prove, as the proposal appears to require for those who transfer property and use a method other than a "prescribed" method, that each of the prescribed methods "would not be likely to lead to an arm's length result." Indeed, proof by any industry of a negative, i.e., that prescribed methods would not be likely to lead to an arm's length result, is an exceedingly difficult requirement. While documentation of taxpayer analysis of other methods actually considered but rejected could appropriately be required, forcing taxpayers to apply a list of prescribed methods and to show that the result is not arm's length, is asking too much.

Second, the standard for determining whether a particular transfer pricing methodology will be considered "reasonable" will also be important for purposes of the penalty provisions. For example, the proposed regulations issued by the IRS under section 6662 in January 1993 indicated that a taxpayer's documentation of a particular methodology would be sufficient to satisfy the "reasonable cause/good faith" exception necessary to avoid the substantial understatement penalty only if the taxpayer reasonably believed that the methodology produced a result that was more likely than not (i.e., that had a greater than 50 percent chance) to be sustained on the merits as arm's length. The "more likely than not" standard, applied under current law only in the tax shelter penalty area (section 6662(d)(2)(C), is a very stringent one which is more appropriately applied to evaluating the strength of the authority underlying a legal opinion than to evaluating the reasonableness of a factual pricing analysis. The President's proposal does not adopt the "more likely than not" standard, and we do not believe it would be appropriate to use that standard in connection with his proposal. At most, a taxpayer's position should be considered to have been reasonable if the position has "a realistic possibility of being sustained on its merits." Even this standard, however, is arguably too high since, under the section 6694(a) preparer's penalty from which it is taken, it is apparent that a tax return preparer can know of a tax return position for which there was no realistic possibility of success and still have "reasonable cause and good faith" in taking that position. Clearly, "reasonable cause and good faith" cannot be declared to require a "more likely than not" standard under section 6662 without creating a very unfortunate inconsistency with section 6694.

Finally, some of the as-yet undeveloped details of the President's proposal may also be important to the workability of the proposal in practice. For example, it would be useful as a practical matter to confirm, as indicated in Secretary Bentsen's testimony to this Committee, that documentation will be considered "contemporaneous", as it is under the proposed regulations, as long as it is completed by the time the taxpayer files its return for the year in question, rather than at the time of the related party transaction. Similarly, for taxpayers with in-house professional staffs engaged in performing the analyses necessary to apply a particular transfer pricing methodology, it will be important to confirm that reliance may be placed on the opinion of such in-house professionals, and that, in appropriate cases, those professionals include members of professional actuarial societies.

The Honorable Dan Rostenkowski, Chairman
Chief Counsel and Staff Director
Committee on Ways and Means
April 12, 1993
Page 4

Assuming that these important ancillary issues are adequately dealt with, we believe that the President's proposal represents a commendable approach to resolving the current concerns surrounding international transfer pricing, and we urge your favorable consideration of this proposal.

Sincerely,

Leonard B. Terr

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Mary C. Bennett

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Counsel for Continental European
Insurance Coalition

Council For Rural Housing And Development

STATEMENT OF THE COUNCIL FOR RURAL HOUSING AND DEVELOPMENT BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

MARCH 23, 1993

CONCERNING EXTENSION OF THE LOW INCOME HOUSING TAX CREDIT

This statement is submitted for the hearing record by the Council for Rural Housing and Development, in conjunction with the Committee's hearings on President Clinton's economic proposals, and in particular the President's proposal to extend permanently the low income housing tax credit. As a matter of background, the Council is an organization of over 350 developers, financiers and managers of projects under the Farmers Home Section 515 Rural Rental Housing Program. Our membership also includes 22 affiliated-member state associations.

Extension vs. Termination

The Committee meets today to consider whether to extend permanently the Low Income Housing Tax Credit, as proposed by President Clinton. Concerning the low income housing tax credit, we have found ourselves for the past several years in the terrible predicament of not knowing until literally the last day of the Congress whether the program would be extended for another year. Obviously, the program was allowed to expire last June. This uncertainty causes great difficulty for people who build housing, as they must decide whether to purchase land for a project, commission plans, and maintain ongoing staff commitments without the guarantee of the tax credit program in place. It is especially a hardship for small rural builders. The low income housing tax credit must be made permanent.

Tax Credits: A Program That Works

As a matter of background, it is important to note that the private sector has never been able to build low income housing in rural areas (or for that matter, anywhere) with subsidies alone. In the case of the Section 515 rural rental housing program, the subsidies benefit the tenant through lower rents, and not the owner. The only incentive to the owner in the basic program design is an 8% return on a required 3% equity involvement, hardly an inducement to any developer. It thus takes incentives through the tax law to stimulate the necessary participation. Without the low income housing tax credit, or another tax incentive, the Section 515 program would simply cease to function. The tax credit program has worked as it was designed to work. We estimate that over 70,000 units of Section 515 housing have been assisted by the tax credit in the six years of the tax credit program's existence. Assuming an average of 3 persons per household, more than 200,000 rural Americans now live in decent housing - which they would not otherwise have -due to the tax credit program.

Contrary to earlier skepticism, we are happy to report that the program has been well and effectively administered on the Federal level by the Treasury Department and IRS. These agencies have issued regulations designed to make the program workable, and by and large they have interpreted the statute quite reasonably. In addition, the state housing agencies have also done an excellent job overall in allocating the credit.

However, the issue is not how well the program works for those who provide the housing or financing. The bottom line question is, what does it do for the low income Americans for whom the program is designed? As we mentioned before, more than 200,000 of our fellow citizens in Rural America have decent housing because of the program and the total number housed will soon be well over a million.

In November 1991, CRHD was pleased to present to Chairman Rostenkowski petitions from 7,200 residents of rural tax credit projects saying how much they appreciated their housing and that other low income citizens should not be denied access to similar housing. That is what this program is all about. The reason to extend the program is not that

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developers are happy with it, or financiers are happy with it, but that hundreds of thousands of Americans are well-served by it. Simply stated, the program works.

There is yet another reason to extend the low income housing tax credit, and that is the jobs that it produces in rural America. According to the National Association of Home Builders, each unit of new multi-family rental construction produces .826 person years of labor. Consequently, the low income housing tax credit has meant over 50,000 jobs that would not have otherwise existed in rural America. Starting with the great depression and in every recession since, subsidized housing has been utilized as a tool to stimulate the economy. Needless to say, the need to produce more jobs is as pressing now as it has ever been in any of our economic downturns. There is no better way to provide jobs than to permit a program that has produced jobs in the past, and is providing jobs in the present, to continue in the future.

Recommended Changes

Significant changes that have greatly improved the program have been made through tax legislation during the past five years. There are a few remaining items that we consider important to the continued success of the program.

In general, the program would be more efficiently managed and implemented if all low income housing tax credit projects adhered to the same set of regulations, regardless of the year a property received a tax credit allocation.

Base all rents on unit size.

Primarily, we would like to build upon two changes contained in prior law. In 1989, Congress changed the methodology used to determine rents for projects funded with 1990 tax credit allocations and beyond. Under the old rules, rents were based on family size, leading to great uncertainty on the part of project owners as to actual rents that could be projected because of the variations in the number of occupants from unit to unit. It also provided a disincentive for owners to rent to small families since the amount of rent that could be charged to that family would be less than that allowed for a larger family. Under the 1989 amendments to the tax program, there is an imputed family size based on the number of bedrooms. For an efficiency, it is assumed that one person is occupying the project. For a one-bedroom apartment, the number is 1.5 persons, and 1.5 persons is assumed for each additional bedroom. This change permits an owner to calculate with certainty the project's income stream, thus very much facilitating project development.

Unfortunately, this change was not made retroactive to 1987, 1988 and 1989 projects, causing an administrative nightmare for managers of tax credit projects. They must enforce different rules depending on the year the project received its tax credit allocation. The lack of a uniform rule also leads to disparity between payments made by tenant families with similar income. This creates a serious management problem.

In response to concern about tenant rent increases resulting from this change, we would suggest that the increases be phased in gradually, as has been when changes were made in the past - to no more than 10% a year.

Certainly, if the new rules are appropriate beginning in 1990, there is no reason that these new rules should not be appropriate and applied to pre-1990 projects.

Allow full collection of FmHA required rents.

Second, in the 1990 legislation, Congress provided prospective relief for Section 515 projects by allowing the gross rent of a project tenant to be increased to 30% of the tenant's income to the extent that the owner pays an equivalent amount to the Farmers Home Administration as "overage". This problem arises because Section 515 requires an owner to charge 30% of the tenant's actual income for rent, whereas the tax credit's limitation is based on a flat rent at 30% of qualifying income. In 1988, Congress passed remedial

legislation to address similar situations in the case of HUD's Section 8 projects, which also required that tenants pay 30% of their incomes for rent and did so on a retroactive basis. The principle is the same under both rural and urban programs, and indeed, it was commonly believed that the 1988 legislation did encompass the Section 515 program, although Treasury would not accept such interpretation. Therefore, fundamental fairness requires that the 1990 remedial change to Section 515, effective for 1991 allocations and beyond, be made retroactive to encompass all Section 515 projects. Specifically, the law should allow for the full collection of FmHA required rents in tax credit projects as it appears on the FmHA Form 1944-8, Tenant Certification.

Again, this change relieves the project manager of the necessity of enforcing two different sets of rules for determining rents. Further, all Section 515 tenants would be paying 30% of their incomes for rent. As the situation now stands, tenants fortunate enough to be living in pre-1991 projects pay less than the statutory mandated 30% of their incomes for rent while equally-situated tenants in 1991 projects have to pay the required 30%. Again, if this change causes a tenant any significant rent increase, it could be phased in over a three-year period.

<u>Allow students to be tax credit eligible.</u>

In 1990, Congress passed legislation to make full time students eligible for occupancy in a tax credit unit when they are the head of the household and receive Aid to Families with Dependent Children (AFDC). This was a very important program change as it enabled many previously ineligible households to become eligible for tax credit housing. Unfortunately, there are still families being turned away from housing because they do not collect AFDC and therefore do not fall into the narrow window of eligibility for certain students. We believe low income tenants should be encouraged to attend school and so long as they fall into the eligible income definition and meet all the FmHA or HUD requirements (as applicable) for student eligibility, they should not be denied residency.

<u>Allow a tenant to move without losing eligibility.</u>

Once an applicant is qualified as tax credit eligible and moves into a property, that applicant should be permitted to transfer within the property to other units without losing their eligible status. The Farmers Home Administration and management plans sometimes require a household to move to a different size unit in a property when there is a change in household size. This can lead to a tenant being reclassified as ineligible for the tax credit, if their household size would no longer qualify under the family size adjustment rules, because they are viewed as being a new move-in. Had they not been required to move, they would have remained an eligible tenant.

<u>Increase the amount of credit an individual can use.</u>

Under the passive loss rules, individual investors are limited in the amount of low income housing tax credits they may use against tax on non-passive income. This limit is approximately $7,750. We believe that many investors would welcome the opportunity to invest more capital in credit projects but for the limit of approximately $7,750 in credit against taxes on non-passive income. Furthermore, other higher income individuals have reported that a $7,750 credit is just not worth the time and energy it takes to understand the investment.

Many involved in the equity capital industry are finding it increasingly difficult to locate investors interested in this program. The present limit makes it impossible to attract many individuals who have already invested and it discourages other higher income investors. Raising the limit to approximately $20,000, as had been suggested in the last Congress by Congresswoman Kennelly and other members of this Committee as part of H.R. 1566, would free up the badly needed capital and would help assure a steady flow of equity to credit eligible properties in coming years.

However, raising the amount usable under the passive laws does not fully accomplish the goal of providing more equity capital for low income housing properties. The reason is that the Alternative Minimum Tax (AMT) prevents virtually all taxpayers from using even the $7,750 which is otherwise available under the passive loss rules. The AMT problem which exists under present law would continue to exist under the tax rates proposed by President Clinton. Most taxpayers under both present law and the proposed new rates will be able to utilize much less than $7,750.

We would propose that a limited amount of low income housing and historic credits be usable against AMT, specifically that these credits may be used by individuals to reduce AMT liability by up to 25 percent, but not to exceed $20,000. Together with the change proposed above to the passive loss rules, we believe substantial new funds will flow to low income housing as a result.

Allow the credit to be generated more quickly.

In most cases, project investors realize very little return during the first year of their investment because of the rule that units must be initially occupied for them to be credit-eligible. This lack of immediate return is a real detriment to attracting necessary program investment. Congress should consider the tentative allowance of credit to units that are certified as ready for occupancy, subject to recapture if the units are not occupied within a requisite period of time.

Eliminate bond posting requirements.

Under present law, Section 42(j) (6), upon the sale of a building or partnership interest, tax credit recapture can be avoided if a bond which is "satisfactory" to the Treasury Department is posted and the building can be expected to remain low-income. The problem is that there are no surety companies willing to provide such bonds because the party bonded against would be the seller of the property who would no longer have any control over the property's management. The result is that it is very difficult to transfer such projects or interest, even when a change in ownership would be beneficial to the property, tenants and others involved.

We would suggest that the bond posting procedures be done away with altogether. Since 1990, the Code has required that each tax credit property have a restrictive covenant, enforceable by state credit agencies, tenants and others, mandating long-term low income use. The purchaser of the project would be subject to that restrictive covenant and if the purchaser attempted to violate its provisions, the restrictions could be enforced in court. Thus, the recapture provisions, which were enacted with the original program in 1986, have become obsolete in light of the more recently enacted restrictive covenant provisions, which can be utilized to assure that the property remains low income, which was the intent of the recapture provisions. To the extent that pre-1990 properties are transferred, avoidance of recapture could be conditioned upon the purchaser agreeing to the placement of a restrictive covenant on the property for the balance of the original 15-year compliance period.

Alternatively, Congress could simply provide that liability for all recapture, commencing with the beginning of the credit period, be borne by the purchaser of the property, or partnership interests, as the case may be. Under present law, Code Section 42(j)(5), partners in "large" partnerships (i.e., 35 or more partners) do not generally suffer recapture on the transfer of a partnership interest. Any recapture which occurs later, for instance resulting from noncompliance, is allocated among the then existing partners, commencing with liability from the onset of the credit period. The same concept (without the necessity of requiring 35 partners) could be extended both to property dispositions and partnership transfers in all partnerships.

Income earned on restricted reserves.

A number of low income project owners are required by lenders or government program rules to maintain various reserve accounts, e.g. replacement reserves or reserves comprised of income which cannot be distributed to owners because of income distribution limits (known as "residual receipts"). Interest earned on these reserves is classified as portfolio income and is taxed to the owners, i.e. partners in the owning partnership in most cases, even though lenders and/or program rules prohibit distribution to the owners. In other words, this amounts to phantom income which, because it is portfolio income, cannot be offset by any passive losses which the property might generate. This is a terribly unfair situation which discourages investment in low income housing.

We would ask the Committee to consider amending the Code either to provide that the income earned on such restricted reserves is considered to be passive income, or alternatively, that such income would not be considered taxable until such time as the reserves were actually distributed to the owners, e.g., when replacement reserves were actually utilized to renovate a project.

Simplification of Reporting Tax Credits.

One of the chief complaints that investors continuously register is that the process of reporting their allocation of tax credits to the IRS is a confusing, time consuming and expensive burden. The typical partner in a tax credit partnership is required to file 12 to 14 additional forms with the IRS stemming from the ownership of their partnership interest. Not only is this burden unfair, it discourages investment; it is just not worth the hassle to many potential investors.

We are well aware of the Chairman's interest in and support for tax simplification. While the reporting process is not generally a legislative matter but is one largely controlled by the IRS, we would ask the Chairman to urge the IRS to take immediate steps to simplify the reporting process. One suggestion that has been made is that credits be reported on a Form 1099, which we believe would help greatly. In any case, we would be pleased to work with the Committee and the IRS in addressing this matter.

We thank the Committee for its consideration of our views and are happy to provide any additional information upon request.

April 22, 1993

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The undersigned companies fully share the President's twin objectives of a lower federal budget deficit and a more productive economy. We believe that a well-ordered corporate income tax is important to the achievement of both objectives.

The signatories have for many years advocated that the corporate income tax should have the broadest possible tax base and the lowest possible tax rate. The great majority of tax economists and practitioners in the United States believe it as well. The broad-base and low-rate principle is the organizing principle of federal corporate tax law. It is how the government gets the best results from its corporate tax policy, whether judged by economic efficiency, equity, or administrability.

We urge the President and Congress to be steady about keeping a broad-base, low-rate corporate income tax. An increased corporate tax rate to pay for an investment tax credit would be a regression toward the broad-loophole, high-rate system which Congress repudiated in 1986 as economically inefficient, unfair, and complex. We believe that the current corporate tax rates should be maintained and that the proposed investment credits should be withdrawn.

Congressional Intent: The 1986 Act

The current structure of the corporate income tax was enacted in 1986, after 18 months of Congressional inquiry and debate that resulted in the Tax Reform Act of 1986 and a corporate income tax increase averaging $30 billion per year.

The Honorable Dan Rostenkowski
Page - 2 -

What did Congress think it was achieving? The House Committee on Ways and Means gave this comprehensive explanation:

"To correct the many problems of the present tax system, the committee believes that it is of utmost importance to reduce marginal tax rates. Lower rates reduce the tax burden on many taxpayers, the predominance of tax considerations in business and personal decisions, and the bias in favor of consumption over saving. The goal of lower marginal rates can best be achieved by reducing and eliminating inefficient subsidies and unintended preferences in the Code. By closing loopholes and eliminating abuses, this bill helps ensure that no individual or corporation will excessively transfer tax burdens to other taxpayers by manipulating the tax system. The bill contributes greatly to improving the equity of the tax system and the efficiency of the economy, without altering the total tax revenues collected."

The Senate Committee on Finance was more pointed:

"The current tax system intrudes at nearly every level of decision-making by businesses and consumers. The sharp reductions in personal and corporate tax rates and the elimination of many preferences will directly remove or lessen tax considerations in business and consumptions decisions. Business will be able to compete on a more equal basis, and business winners will be determined more by serving the changing needs of a dynamic economy, and less by reaping the subsidies provided by the tax code."

Why Corporate Income Tax Rates Matter So Much

* The corporate income tax is a tax on investment returns. The nation's economic welfare in the future depends on the investments that we make today. Raising the tax rate on investment returns will mean less investment, less employment, and less improvement in living standards than otherwise would occur.

* The corporate income tax is a double tax. Returns to equity investments in corporations are taxed twice--once at the corporate level and again at the personal level when dividends are paid or stock is sold. The U.S. is the only major industrialized country that does not mitigate this double tax, which can be more than 50 percent. Raising the income tax rate would levy an even steeper double tax on investment returns in the U.S.

* Higher corporate income tax rates will inevitably be followed by the reinstitution of tax preferences for some.--This was the very tax structure that Congress worked so hard to be rid of, for reasons quoted above. That high tax rates are the economic and political fuel for special tax preferences or "incentives" is simply a matter of record. Indeed, the Administration's own budget proposal contains an investment tax credit--available only to certain businesses that buy certain kinds of property during a certain time period--to counteract the anti-investment effects of higher tax rates.

* Higher corporate income tax rates will impair our international competitiveness.--Numerous countries cut their corporate income tax rates in response to the lower U.S. rates enacted in 1986. If we were now to raise our tax rates and others followed with higher tax rates too, worldwide taxes on investment returns to U.S.-based companies would go up by more than any gain to the U.S. Treasury. In that case, investors in foreign-based companies would be less affected because of corporate integration mechanisms that the U.S. does not have. On the other hand, if our competitors do not follow our higher rates, then the U.S. itself would become a less attractive site for investment.

* Arbitrage? For a while, a theory of "arbitrage" was circulating to the effect that the corporate income tax rate must go up, for technical reasons, if the top individual income tax rate were increased. Otherwise, unincorporated businesses would reorganize as corporations in order to enjoy an apparently lower tax rate. The "arbitrage" theory has died out, however, because it lacks realism. As noted above, incorporation is generally the ticket to double taxation, not to tax savings. Because of

double taxation, equality of the corporate and individual income tax rates is a false harmony that is not required for technical reasons of sound tax policy.

Du Pont Company
Eastman Kodak Company
Emerson Electric Company
Genentech, Inc.
General Electric Company
General Mills, Inc.
General Motors Corporation
Hallmark Cards, Inc.
Honeywell, Inc.
IBM Corporation
Merck & Co, Inc.
3M Company
PepsiCo, Inc.
Philip Morris Companies, Inc.
The Pillsbury Company
The Procter & Gamble Company
The Quaker Oats Company
Sara Lee Corporation
Westinghouse Electric Corp.

TESTIMONY

OF THE

EUROPEAN-AMERICAN CHAMBER OF COMMERCE IN WASHINGTON, DC., INC.

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON THE

CLINTON ECONOMIC PACKAGE

Introduction

The European-American Chamber of Commerce in Washington, DC is pleased to provide the Committee on Ways and Means its views on President Clinton's economic package. Our remarks are focused on those provisions which have a particular impact on our member companies, specifically the proposals on earnings stripping and transfer pricing. Since the Chamber was formed a few years ago, most of our tax concerns have centered on proposals which would treat US companies with European parents differently from other US companies. For that reason, we would also like to take this opportunity to provide the Committee with information on the contribution European-affiliated US companies make to the US economy.

The European-American Chamber of Commerce is a joint endeavor of the European and American business communities to promote and sustain a healthy, open and mutually beneficial business climate in both the United States and Europe.

The Chamber seeks to advance policies that foster greater economic growth in the trans-Atlantic trade and investment relationship. This economic partnership is substantial and mutually beneficial, involving $400 billion in cross investment, $220 billion in two-way trade, and total investment-related employment of nearly 6 million workers.

European-affiliated US companies pride themselves on being good corporate citizens and clearly make an important contribution to the US economy. Because of their positive impact, the Chamber believes that European-affiliated companies should not be discriminated against in terms of investment, tax or trade policy.

Impact of European Affiliated US Companies -- Investment and Jobs

European based investment in the US provides a steady flow of funds and jobs to the American economy. The bulk of all US investment from abroad comes from European firms. These companies' US investments now exceed $400 billion and benefit the American economy through:

- **Job creation** -- European firms provide jobs in every state of the US. European

and services. The above-average salaries European subsidiaries pay their workers also stimulate the economy indirectly by sustaining increased consumer demand for goods.

- **Skill and technology transfer** -- Alliances with European firms--which are world leaders in their field--enable American companies to tap into global resource-and-skills networks that are on the cutting edge of technology. This helps keep US production methods competitive globally.

- **Philanthropic contributions** -- Realizing that businesses prosper when communities prosper, European firms have started numerous programs that foster education, improve neighborhoods, support the arts and preserve the environment in the regions where they operate.

Many European-affiliated US firms have maintained domestic production facilities for decades and believe their ongoing investment in the US market reflects a clear commitment to manufacturing for the United States *in* the United States. Communities and workers clearly benefit from the open investment relationship the United States has historically enjoyed with Europe. States have long realized the contribution these companies can make to local economies, and actively recruit new investment.

US business has benefited as well. The United States' open investment relationship with Europe has meant that American companies have been able to share in the benefits of European integration. In fact, US multinationals sell more in the EC than any where else, including North America. Europe is also the United States' most important trading partner, with the US enjoying a nearly $9 billion trade surplus in 1992.

Tax Policies Effecting European-Affiliated US Companies

The Chamber believes that the collection of.taxes from international companies in any jurisdiction should be applied regardless of the companies' affiliation with a parent company abroad. Non-discriminatory tax treatment of international companies helps and encourages firms to compete around the world. The Chamber believes that tax issues should be guided by the following principles:

- <u>National treatment.</u> Tax rules should not discriminate against corporations with nonresident shareholders. US affiliates of foreign corporations should be taxed in the same manner as US-owned corporations. Similarly, US-owned foreign corporations should be taxed in the same manner as foreign-owned foreign corporations. National treatment is the central principle of international trade law and bilateral income tax treaties. Countries that depart from national treatment in the pursuit of their self-interest, inevitably provoke retaliation that leave all countries worse off.

- <u>Reduction of tax barriers to cross-border investment.</u> The interaction of US and foreign income and withholding tax rules frequently cause cross-border investment to bear a higher tax burden than domestic investment. Such rules are the equivalent of tariffs on export capital and impede the investment flow and efficient worldwide allocation of capital.

- <u>Expansion of tax treaty network.</u> Bilateral tax treaties have proved to be one of the most useful tools for advancing national treatment and reducing barriers to cross-border investment. The European Chamber strongly

Impact of the Clinton Economic Package on European-Affiliated US Companies

The Chamber believes that the Clinton economic package advances tax proposals that directly target US affiliates of European companies. These proposals ignore the fact that the net contribution of European-affiliated firms to the US economy is no less than other US companies. US companies of European parentage are proud of their positive contribution to the US economy, in terms of the number of jobs they support, the higher wages they provide to US workers, and the value added to the technology base.

Discriminatory and burdensome policies contained in the Administration's proposals on transfer pricing and earnings stripping, work against companies which clearly contribute to the US economy. They also run counter to the Administration's goal of creating jobs and improving the overall economic health of the United States.

Enhanced Earnings Stripping Proposal

This proposal is intended to address the two kinds of perceived abuses wherein a subsidiary borrows from a parent company abroad (where it is assumed they pay lower tax rates [See Exhibit 1.1], and then deducts interest paid to the parent instead of paying out dividends on earnings, which are subject to US tax. A variation of this perceived abuse could occur when a parent company issues its guarantee to a bank, which in turn lends money to the subsidiary. If that subsidiary is perceived as being "thinly capitalized", the alleged abuse is that the parent may pay more interest expense (and less tax) in the US, than in the home country (which again is assumed to be a lower tax location). Also under suspicion are so-called "back-to-back" loans and other "conduit" type arrangements. A "back-to-back" loan occurs when a parent company makes an interest-bearing deposit with a bank, which in turn lends the money to the US affiliate. The US affiliate would receive a tax deduction for interest paid to a bank, while the same bank pays interest to the affiliate's parent overseas, less a "spread", or commission, for its assistance.

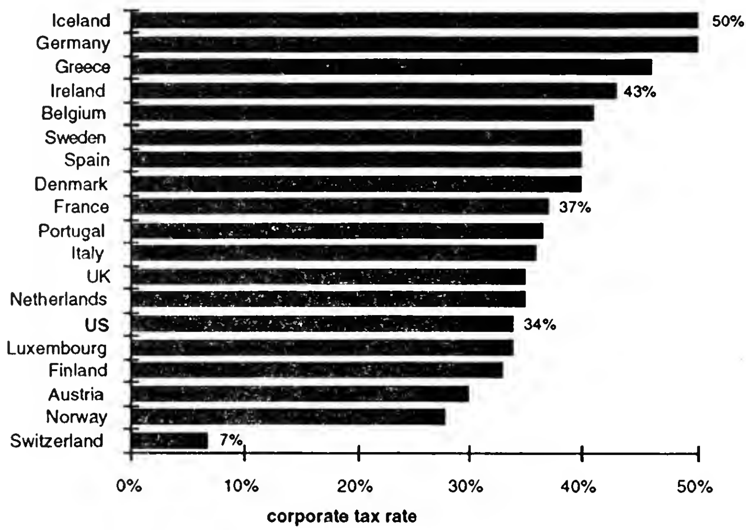
Currently, Section 163 (j), which the Administration proposes to "enhance", was enacted in 1989 over the strong objection of the Treasury Department. Under Section 163 (j), and proposed regulations issued on June 12, 1991, a deduction for interest paid or incurred by a US subsidiary to an "exempt related person" is disallowed if the interest is deemed "excess interest expense", and the subsidiary's debt-to-equity ratio exceeds 1.5 to 1. A US subsidiary is deemed to have "excess interest expense" when the interest paid to an "exempt related person" exceeds 50 percent of the subsidiary's "adjusted taxable income". "Excess interest expense" can be carried forward. The debt-to-equity ratio operates as a safe harbor, but must be satisfied each year.

The legislative history to Section 163 (j), and the June 1991 regulations, anticipated further regulations to address the perception of abuses due to guarantees and "back-to-back" and other "conduit" loans noted above. With regard to the effective date of the regulations the legislative intent behind Section 163 (j) also specified: "The conferees expect that any such regulations would not apply to debt outstanding prior to notice of the rule if and to the extent that the regulations depart from positions the Service and the Treasury might properly take under analogous principles of present law that would recharacterize guaranteed debt as equity." [1]

In the "Summary of the Administration's Revenue Proposals", Section 163 (j),

Exhibit 1.1

INTERNATIONAL CORPORATE TAXATION RATES



Notes:
Rates shown are for federal government only. Several countries apply lower rates to corporations with profits below a certain threshold. Ireland taxes the manufacturing sector at 10%. Switzerland uses a progressive tax rate schedule, with rates ranging from 3.63 to 9.8 percent; 7 percent is an average. The Netherlands taxes the first GLD 250,000 of profits at a higher rate (40 percent).

Source: "Taxation in OECD Countries," Paris, 1993, p. 66 (1990 data)

deductibility of interest in situations where the lender would make the loan even without the parent guarantee. This directly conflicts with the 1989 legislative hsitory which contemplated that the regulations would be issued distinguishing "ordinary course" guarantees from "nonordinary course" guarantees, and that only the latter would be attacked. In addition, the new proposal would apply to any interest paid or accrued in taxable years commencing after December 31, 1993, without grand- fathering interest paid or due under existing obligations.

The EACC believes that current Section 163 (j), even without "enhancement" of the Code is discriminatory in that it treats foreign-owned US companies with owners abroad less favorably than domestically-owned businesses. This is an affront to the US bilateral income tax treaty standard which obligates the United States to treat subsidiaries of foreign companies fairly. None of the member states of the European Community have enacted rules similar to the Administration's provisions, with the exception of France, which has promulgated minimum debt-to-equity rules which apply to domestic French firms as well. The

Section 163 (j) and the Administration's "enhancements" are largely based on the assumption that US affiliates actively use earnings stripping because they enjoy lower tax rates in their parent countries. However, parent companies based in European countries, which account for $258 billion and 63% in 1991 of total foreign investment in the US actually tend to incur corporate tax rates in their home countries that are equal to or higher than US corporate tax rates. In 1991, countries accounting for 85.8% of total European investment in the US subjected these parent companies to corporate tax rates equal to the current US rate or higher (See exhibit 1.1). The suspected motive for earnings stripping simply does not exist for European businesses.

The Administration's proposal to "enhance" earnings stripping legislation comes three years after Section 163 (j) was enacted, but before guarantee regulations could be issued and commented on by taxpayers. The delay of three years in adopting regulations to enforce Section 163 (j) is evidence of the difficulty in writing regulations for a flawed underlying statute. Loans have often been made to US affiliates of European companies that would be made "in the ordinary course" of business without a parent guarantee. Furthermore, debt-to-equity ratios appropriate for one particular industry are totally inappropriate for other industries. Regulation writers faced the task of devising fair, mechanical tests which would allow interest deductions for loans obtained "in the ordinary course", while disallowing interest on "bad" loans.

In the face of these difficulties, the Administration is attempting to "enhance" the rules by characterizing all guaranteed debt as "bad", and allowing no transition period for guaranteed debt that is already on the books. This approach includes loans made by US banks, where earnings stripping is impossible since interest paid by a borrower to a US bank is subject to US tax.

Should the Administration's legislation apply against interest paid or accrued after December 31, 1993, it would disregard the legislative intent of existing law. Retrospective treatment is fundamentally unfair to debt negotiated before that date. It will result in expensive renegotiation of guaranteed bank loans and repurchase of guaranteed public debt where the terms of the debt, in most cases, do not allow the borrowers to call the debt based on a tax change which denies interest deductions. This kind of higher expense will result in less income, and less tax. Yet this is only one revenue losing aspect of the proposal.

The Treasury Department estimated in it's February 1993 proposal, that its "enhanced" earnings stripping rules would raise revenues by almost $600 million. The Joint Committee on Taxation has lower expectations of only $165 million. However, a strong case can be made that the new proposals will actually reduce tax revenues.

Banks in the US and elsewhere, underwent a period of serious loses in the late 1980's. As a result, banks tightened credit requirements encouraged by authorities, which raised banks' capital requirements as part of these tightened credit policies. They now look very carefully at the credit worthiness of a US subsidiary before they lend, and they also require guarantees from foreign parent companies, mainly in startup situations where the US affiliate has no credit history. Optionally, for larger loans, they may ask for a parent guarantee in return for a lower borrowing rate. Given these developments, the impact of "enhanced" earnings stripping is easy to predict. The results are exactly the opposite of those intended.

Large borrowers, who used parent guarantees to negotiate slightly lower interest

believe that parent companies have been afraid to renew guarantees or set up new guaranteed loans. Our discussions with investment officials of European governments indicate that while they still view section 163 (j) as discriminatory, they have not considered retaliation because companies have changed their debt structures and are not complaining about it. It is arguable that any earnings stripping abuses which may have existed no longer exist.

Where no advantage for earnings stripping exists, there is no need for earnings stripping regulation. As pointed out above, countries accounting for 85.8% of total European investment in the US subjected these parent companies to corporate tax rates of 34% or higher. An important modification would be to allow the deductibility of interest on loans guaranteed by parents residing in countries having tax rates comparable to the US. Additionally, startup operations from any country should be allowed to deduct interest on loans when backed by parent guarantees for a limited period of time, such as three years. Finally, grandfathering provisions should be made for guaranteed loans which are already on the books.

Passage of "enhanced" earnings stripping proposals will probably result in less, not more revenue. Many believe that Section 163 (j) has already had negative impact on investment and growth. Necessary modifications can be accomplished through regulation, rather than enacting additional complex legislation.

Transfer Pricing Initiative

This proposal appears aimed at perceived problems in applying penalties that were enacted in section 6662 (e) of the Code in 1990 and the general provisions under section 482. The Administration's proposal, new temporary regulations applying to Section 482, and the 1990 law, attempt to address a situation in which multinational firms import goods and services from affiliated companies abroad at an artificial price, and that this "transfer price" (the transfer price being the price charged between the affiliated firms) allows them to reduce the amount of tax they pay in the US.

It is alleged that by raising the price of some goods and services international companies can shift income out of the United States to a lower tax jurisdiction abroad. This concept presumes that a motivating factor exists, and that the foreign jurisdiction imposes less tax on income than does the US. As noted above, in the case of the majority of European countries, this is not true (see Table 1.1).

Current law requires that companies prove that the transfer price of a good or service is similar to a transaction with an unaffiliated company. This is commonly referred to as the "arms length standard".

On January 13, 1993, the Internal Revenue Service provided new temporary Section 482 regulations that affirmed the "arms length standard", but would replace current rules applicable to inter-company transfers of intangibles and modifying current rules in regard to tangible property. The new regulations also provide new methods which may be used to account for profits and pricing. In terms of penalties, the proposed regulations for substantial valuation misstatements would carry a 20% of misstatement penalty, and gross valuation misstatement would carry a 40% penalty in sections 6662 (e) and 6662 (h).

The Administration's proposal on transfer pricing would only apply the "reasonable cause and good faith exclusions" to the 6662 (e) penalties if companies provide the IRS with contemporaneous documentation to justify the methodology

"arms length standard", without the onerous task of proving the negative neglected methods.

The Chamber perceives a number of problems in this transfer pricing proposal:

- The Administration's proposal does not make clear when the taxpayer is required to provide its "contemporaneous" documentation: at the time of the related party transaction, or at the time of the tax return for the year in question. The work involved in documenting and analyzing a transfer that meets the "arms length standard" is difficult. It strikes us as impossible to do at the time of the transaction.

- The applicability and justification of "other" methods, should the taxpayer choose a methodology outside one of those "specifically prescribed" in the 482 regulations, creates a serious and onerous task for companies. It results in a situation in which the taxpayer will have to defend the "reasonableness" of its methodology by using an unprescribed method. Trying to prove a negative, in that none of the "prescribed" methods produce an "arm's length transfer price", is an enormous burden and likely unattainable.

- The documentation requirement is excessively broad. Aimed at ensuring the accuracy of the "arm's length method", the requirement is crafted to capture too wide a number of transactions given the low threshold for application of the penalty for large corporations. For aggregate Section 482 adjustments of more than $10 million per year, a 20% penalty will apply, and a 40% penalty will be imposed on adjustments above $20 million per year. Such limits could be easily exceeded by a large corporation, even if the adjustment is relatively small. Consequently, the comprehensive documentation requirement of the "arm's length requirement" will apply to a very large number of inter-company transactions for large international companies. This Section could require an extremely large documentation burden on thousands of products.

- "Reasonable Cause", under Section 6662, applies an inappropriate test under this Section. It requires that the documentation of a taxpayer's chosen methodology must show that the methodology produced a result that was more likely than not to be sustained on the merits as "arm's length method". This "more likely than not" standard is one that is usually reserved for evaluation of a legal opinions, rather than evaluation of the reasonableness of a pricing analysis.

The penalties and requirements in this Section are coupled with a transfer pricing enforcement initiative. We appreciate that this is aimed at those taxpayers whose current transfer pricing practices are not sufficiently focused on compliance with the arms length standard. The Chamber does not oppose such an initiative, but hopes that the Committee will insure that this endeavor results in expedited review of returns rather than simply an expansion of invasive and time consuming investigations.

The Chamber appreciates that the proposal is applied on predominately a non-discriminatory basis, although we would note that it will create a heavier documentation burden on foreign affiliated US firms. We also appreciate that the proposal intends to maintain the "arms length standard" and does not resort to protectionist, discriminatory ideas such as "formulary apportionment," "unitary" or minimum taxes. Such proposals would establish a huge disincentive for investment in the United States and could erode the healthy economic environment of European affiliated US companies have enjoyed for decades.

United States because new businesses are seldom profitable initially." The report adds that "Other countries are likely to treat the minimum tax as a protectionist measure and retaliate with similar taxes on US owned companies conducting business within their borders. If so, then the minimum tax would stifle international trade and reduce economic welfare throughout the world."

Conclusion

It is clear that European-affiliated companies are good US corporate citizens. They want and deserve to be treated like any other US company. The earnings stripping and transfer pricing provision of the Clinton economic plan do not give full appreciation to the contribution of these firms and clearly place them in a secondary category of corporate citizenship. We trust that the direction of those proposals will be reversed during the process of Congressional consideration of tax legislation, and we would be pleased to cooperate with this Committee in any way to achieve that end. We thank the Committee for the opportunity to share our views and hope that you will take them under consideration.

STATEMENT OF

TIMOTHY P. AGNEW

on behalf of

THE FINANCE AUTHORITY OF MAINE

AND THE COUNCIL OF DEVELOPMENT FINANCE AGENCIES

in support of

PERMANENT EXTENSION OF SMALL-ISSUE MANUFACTURING BONDS

March 31, 1993

Mr. Chairman, I am Timothy P. Agnew, Chief Executive Officer of the Finance Authority of Maine. My agency is a multi-purpose financing authority that serves all areas of the state. Its mission is the creation of jobs and economic growth through a variety of programs that make capital available for business investment. We are the principal issuer of small-issue industrial development bonds. Over the past seven years we have financed 49 projects for over $76.6 million through the use of these bonds, creating or retaining in excess of 4,000 jobs.

Like much of the rest of New England, Maine's economy was particularly hard hit during the late 1980s and early 1990s. During much of that period, IDBs were one of the few capital resource opportunities that enabled our state to move forward with new job-creating projects in the private sector.

In addition to representing the Finance Authority of Maine, I am also providing comments on behalf of the Council of Development Finance Agencies (CDFA), of which I currently serve as President. CDFA represents over 110 state and local government finance agencies in 38 states. These are the government agencies that are the most directly involved in state and local efforts to provide critical financing for business growth. Our members frequently are the ones who supply the access to capital that enables smaller companies to grow and create jobs. Our members' activities range from issuing tax-exempt bonds to administering loan guarantee programs to capitalizing and operating revolving loan funds.

Mr. Chairman, I am pleased that the President has included a permanent extension of small-issue industrial development bonds in his package for long-term economic growth, and I encourage the Committee to give its full support to this component of the plan. Twice last year the Committee recognized the value to the nation's economy of a permanent extension of the IDB program. The need for the program, as evidenced by the backlog of projects that has developed since the program's expiration, is as strong now as it was when this Committee acted last year.

The President was quite right to include this extension as one of the "Capital Investment and Economic Growth" provisions. That is precisely what this program is all about. Small-issue IDBs provide a critical source of affordable, long-term capital for smaller manufacturers. As you know, the lack of available capital is one of the greatest obstacles smaller businesses now face. While we hope that the President's new regulatory recommendations will help ease the credit crunch, the experience of my agency and others suggests that traditional lenders will continue to be slow to satisfy the small business demand for capital. This is particularly true when the question is the need for long-term capital, where time horizons usually exceed the length of most commercial loans. Consequently, there will continue to be substantial demand for access to affordable long-term capital.

Mr. Chairman, I believe the Committee's hearing last year on the expiring provisions examined the critical issues of the IDB program, and I will simply review the major points covered in that discussion.

EFFECTIVE CAPITAL ACCESS FOR SMALLER MANUFACTURERS

First, this is the only federal incentive that is directly targeted to creating jobs in the smaller manufacturing sector. As I believe all the members of this Committee understand, the 1984 and 1986 tax bills eliminated all non-manufacturing uses of small-issue industrial development bonds. No other program is now limited exclusively to manufacturing facilities.

I am sure the Committee is aware of the importance of the manufacturing sector to the strength of the American economy, but I want to call particular attention to the significance of the smaller manufacturing companies. In 1990 roughly one-fifth of all U.S. manufacturing came from small firms, those with assets of less than $25 million. Moreover, the trend in the manufacturing employment data shows that the bulk of the job growth in manufacturing is coming from the smaller plants--which are precisely the ones that benefit from small-issue industrial development bonds.

While the total manufacturing employment during the 1980s was running slightly below the level of the late 1970s, for example, the number of workers employed in smaller factories was actually growing during this period. From 1980 to 1990 the number of workers in smaller plants (those with fewer than 250 employees) grew by over 500,000 while the number of workers in the largest plants (those with more than 1,000 employees) declined by 1,650,000. Even more impressive has been the growth of the very small manufacturing enterprises. During the 1980s, the number of plants with 50 or fewer workers grew by 16%. Renewing the IDB program then, will benefit the very part of the manufacturing sector that is supplying the energy for new manufacturing job growth.

Second, IDBs enable companies to expand and modernize their facilities, thereby increasing their productivity and making them more competitive in an international market. In my state of Maine, for example, a few years ago the Stratton Lumber Company used a $2.1 million IDB issue to replace its aging machinery with state-of the-art equipment. The increased productivity that this equipment made possible enabled Stratton to successfully withstand the competition of Canadian softwood lumber.

A similar example comes from Pennsylvania, where the Johnstown Corporation has become a model for the rebuilding of the steel industry. Johnstown Corporation, located at the site of the previous U.S. Steel Johnstown works, has put 600 people back to work by focusing on strategic niches--in this case purchasing state-of-the-art equipment to manufacture critical components required by steel mini-mills, which is the emerging form of competitive manufacturing and marketing of domestic steel. The Pennsylvania Economic Development Finance Authority provided $975,000 of IDB financing for this new equipment.

Third, IDBs frequently offer the only source of affordable long-term capital for smaller companies. A study conducted last year for the Illinois Development Finance Authority concluded that tight money, credit crunches, and the capital reforms mandated during 1991-92 all discriminate against small manufacturing firms because they disproportionately reduce bank credit to these firms. This contraction in credit is particularly painful for small manufacturers because they depend so heavily on banks to finance their investments and they are less capable than larger firms of substituting bank-loan credit with investment bonds, commercial paper, or equity-market credit.

According to the Illinois study, which examined nationwide data, during the past decade the fraction of bank loans made available to small firms has fallen by more than 40%, while the fraction available to large firms has risen by more than 40%. This finding underscores the critical importance of IDB financing to smaller manufacturers. Quite simply, in many cases it is the only form of long-term financing available to them. Furthermore, it is the most effective mechanism for providing smaller local companies with access to regional or national credit markets.

Finally, IDBs foster a strong partnership between the federal government and state and local governments, utilizing an existing, effective delivery mechanism. They offer an opportunity for the federal government to work with the states, cities and counties in a proven, effective way to create jobs, encourage economic growth, and facilitate the revitalization of the nation's manufacturing sector. The statewide bond volume cap ensures that state and local governments must make careful allocation decisions and determine that the projects financed with IDBs will contribute significantly to the area's economy.

Mr. Chairman, in the past there have been suggestions for further targeting of the IDB program. I think it important to point out that this program is already carefully targeted. Because potential borrowers must comply with an array of federal requirements governing qualifying projects, must secure an allocation under the state volume cap system, and finally must clear additional state and local issuer requirements (e.g., job creation and other benefits tests), many applications fall by the wayside. What are left are those that generate jobs and conform to the current law standards of a qualifying manufacturing project.

Some observers of the program point to the practice of several states that provide allocations on a first-come, first-served basis as evidence that there are no appropriate requirements, such as targeting, governing the use of this financing, in essence allowing agencies to finance whatever projects walk through the door. Such a view fails to understand both the nature of the application process, as discussed above, and the actual operation of the IDB program. The experience of CDFA's member agencies indicates, for example, that a substantial majority of IDB issues go to expand existing manufacturing facilities; they are not used to shift jobs from one state to another. This largely explains why the nation's governors and local officials support the program, a tool that focuses primarily on companies that are already operating in their communities and that need access to affordable, long-term capital in order to create and retain local jobs.

A PROVEN TOOL FOR CREATING JOBS

At its heart, then, the small-issue industrial development bond program is about jobs. For that reason it should be included in any package designed to put the nation's economy on a path to long-term growth.

Although precise national data are not available, the Council of Development Finance Agencies has surveyed a number of states in all parts of the country for their IDB activity from 1987 (after the changes in the 1986 tax reform act took effect) through 1992 (when the IDB program was in operation for only six months). Based upon that data, CDFA estimates that IDBs nationwide have created 182,000 new manufacturing jobs and facilitated the retention of 169,000 jobs through the financing of roughly 3800 projects.

Attached to this statement is an outline of the 1987-1992 IDB experience of several key states.

As you know, we have been unable to use this program since it expired on June 30 of last year. As a consequence there is a substantial backlog of manufacturing projects that are waiting on the financing provided by these bonds in order to proceed with their plans to grow. **A recent survey of selected CDFA members suggests that at least $750 million in economic developments are ready to move forward if Congress renews the IDB extension.** These are projects that have already been identified by economic development agencies through their normal business application process. In many cases the companies have already secured an inducement resolution and are literally just waiting on the renewal of the program.

The data from several states underscores the importance of the program. In Massachusetts, for example, the Massachusetts Industrial Finance Agency reports that 25 projects valued at $92.9 million are awaiting IDB authority. These projects are expected to produce roughly 2000 new jobs--a major boost to New England's sluggish recovery. On the other side of the country, according to California State Treasurer Kathleen Brown, whose office monitors the allocation of tax-exempt issues under the statewide volume cap, California has 12 projects pending, involving $73 million of investment and 1700 jobs. While these figures suggest the strength of state level activity, equally compelling numbers display the value of the program to local communities. Minneapolis has 7 manufacturing projects, with a total investment of $11.2 million affecting almost 200 jobs--all just waiting on Congress to renew the program.

Outlined below is a summary of the projects that are awaiting congressional action on an IDB extension in a variety of states.

SUMMARY TABLE

State	Volume (millions)	Projects	Jobs (To be created)
Arkansas	$42.05	11	590
California	$73	12	1700
Illinois	$53.5	13	880
Massachusetts	$92.9	25	2000
Nevada	$62.8	11	1141
North Carolina	$122.6	31	1980
Pennsylvania	$43.3	23	942

It is important to note that these are not potential projects. These are projects that could begin moving immediately when the IDB program is reinstated. Unfortunately, in a number of cases, the expiration of the program has caused companies to abandon their plans to use tax-exempt financing for plant expansion.

IDBS ENJOY BROAD SUPPORT

Mr. Chairman, there is strong support for an extension of the small-issue industrial development bond program. Last year, a majority of House Members cosponsored legislation calling for an extension of the program. This year, Rep. William Coyne has sponsored H.R. 827, which would permanently extend IDBs. That legislation enjoys the cosponsorship of 23 members of this Committee. In addition, the National Governors' Association, the National Association of Counties, and the National League of Cities have all called for putting this program on a solid, permanent foundation.

In addition to permanently extending the program, we also encourage the Committee to consider some minor changes that will enhance its effectiveness. One of the most beneficial would be an increase in the capital expenditure limit for companies using this tax-exempt financing from $10 million to $20 million. The original $10 million cap was set in 1978 and applies to the amount of total capital investment that can be made over a six-year period, from three years before the bond issue through three years after the bond issue.

Since the $10 million limit was set in 1978, its value in constant dollars has seriously eroded, excluding many of the firms which the program was originally designed to assist. Raising the capital expenditure limit to $20 would partially offset the effects of inflation and would make many of these smaller firms eligible to finance a portion of their capital investment needs through tax-exempt funds. Last year the Congress approved an increase in the capital expenditure limit to $20 million, and we hope the Committee will include a similar provision in this year's tax package. At the same time, we are not requesting any increase in the limit on the size of the bond issue, which would remain at $10 million.

In addition, CDFA will continue to work with members of the Committee and staff to review other programmatic changes, such as strengthening the market for smaller bond issues through the limited restoration of bank deductibility, streamlining the manufacturing definition to make IDBs more effective in addressing the environmental needs of these manufacturing companies, and permitting additional on-site research and development activities to be associated with eligible manufacturing projects.

In conclusion, Mr. Chairman, we believe the history of the IDB program over the last several years demonstrates its value in stimulating local job creation. The number of manufacturing projects that are currently waiting for the program to be renewed underscores its continued importance in today's uncertain economic climate. We encourage this committee to help the long-term capital investment needs of smaller manufacturers by providing a permanent extension for this proven tool for economic growth.

Thank you for the opportunity to share our thoughts with the Committee.

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JOB CREATION AND RETENTION
and
SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS

Selected States for 1987-1992

STATE	VOLUME	PROJECTS	EMPLOYMENT	IMPACTS
	in millions	number	New Jobs	Retained
Arkansas	$435	147	5,421	n.a.
California	$396	117	10,389	11,851
Illinois	$482	107	4,322	10,045
Indiana	$577	187	7,295	1,911
Maryland	$118	37	695	1,730
Massachusetts	$567	78	2,322	n.a.
Missouri	$183	105	4,268	n.a.
Nebraska	$69	21	1,090	129
Ohio	$747	280	11,958	15,980
Pennsylvania	$451	224	8,975	17,724
Texas	$210	40	2,489	n.a.
Virginia	$300	119	8,697	1,077
Washington	$218	63	3,747	n.a.
ALL STATES (estimate 2/93)	$12,000	3,800	182,000	169,000

sources (respectively):

Arkansas Development Finance Authority
California State Treasurer's Office
Illinois Development Finance Authority
Indiana Development Finance Authority
Maryland Dept. of Economic & Employment Development
Massachusetts Industrial Finance Agency
Missouri Department of Economic Development
Nebraska Investment Finance Authority
Ohio Department of Development
Pennsylvania Department of Commerce
Texas Department of Commerce
Virginia Department of Economic Development
Washington State Department of Trade Economic Development

TESTIMONY FOR THE RECORD BY THE FOREIGN-BASED CORPORATION ACTION GROUP

I. INTRODUCTION

These comments are submitted to the House Committee on Ways and Means on behalf of the Foreign-Based Corporation Action Group, a diversified group of European and Canadian companies with significant operations in the United States. Our comments deal with the Clinton Administration's proposals on the earnings stripping and transfer pricing rules.

We also want to comment on the importance of international tax treaties and the need for greater harmonization of U.S. tax rules with international norms. In today's global economy, both U.S.- and foreign-based companies increasingly have integrated operations that cross national frontiers. In this economic setting, failure to abide by international principles of taxation can have significant adverse repercussions for capital exporting and importing countries.

Before we present our comments, it is important to put into perspective the role of European and Canadian companies in the U.S. economy. According to the May, 1992, Survey of Current Business, in 1990, U.S. subsidiaries of European companies employed 2.9 million U.S. workers -- 3 percent of all jobs in the economy. Canadian subsidiaries employed another 740,000 U.S. workers, bringing the total number of jobs in the U.S. economy that European and Canadian subsidiaries are responsible for to 4 percent of the total U.S. workforce, more than all other nations combined. The subsidiaries of both European and Canadian companies pay higher wages, on average, than U.S. companies as a whole. European investment in gross property, plant, and equipment in the United States in 1990 was $291 billion; for Canada, the figure was $106 billion. Expenditures for new plant and equipment totaled $31.4 billion for Europe and $11 billion for Canada.

In addition to being our most important trading partners, European and Canadian companies provide substantial stimulus to the U.S. economy. The investments by U.S. subsidiaries of Canadian and European multinationals are long-term and ongoing, demonstrating a clear commitment to operating in the United States.

II. U.S. INTERNATIONAL TAX POLICY

When the United States overwhelmingly dominated the world economy, as it did in the 1960s and early 1970s, the adverse consequences of nonconforming tax rules were limited by the lack of major foreign competitors and the tendency of other countries to adopt U.S. tax changes. With increased worldwide integration, and the emergence of Europe and the Pacific Rim as rivals to North America as regional superpowers, differences among U.S. and foreign country tax rules are much more likely to interfere with the operations of U.S. multinationals overseas and foreign-based competitors in the United States.

Of primary concern to the Foreign-Based Corporation Action Group are recent proposals to adopt a formulary approach to the taxation of U.S. subsidiaries of foreign corporations. It should be noted that there is universal acceptance of the arm's-length standard in all bilateral agreements, not only between the U.S. and its trading partners, but among those countries as well. The U.S. model tax treaty specifically endorses the arm's-length approach, and the numerous legislative changes on transfer pricing have left the basic concept of arm's-length pricing untouched. In addition, the Organization for Economic Cooperation and Developement has endorsed the arm's-length principle.

These fomulary recommendations, combined with a series of proposals that would statutorily override decisions will work to the disadvantage of both U.S. and foreign based multinationals. Foreign governments and their taxing authorities will regard the

U.S. as an unreliable treaty partner and will face political pressure to enact retalitory legislation.

A current example illustrates the type of situation we envision. California uses the worldwide combined method of accounting when determining the taxes owed by foreign-owned companies. In a brief filed on a case which the Supreme Court is expected to hear (*Barclays Bank PLC v. Franchise Tax Board)*. Various business organizations pointed out that the worldwide combined reporting method of state taxation has provoked an extraordinary degree of "international furor." The U.S. Secretary of State advised the Governor of California that the United States has received diplomatic notes objecting to the worldwide combined reporting method "from virtually every developed country in the world."

More to the point, however, California's use of the method prompted the United Kingdom to pass retaliatory legislation in 1985. Although this legislation has never been implemented, it would withdraw certain tax benefits from U.S. parent corporations operating in worldwide combination states.

Although the retaliatory legislation in the U.K. relates only to the unitary tax issue, the possibility of additional retaliation is not unrealistic. Recent legislative and regulatory initiatives in the United States which have focused primarily on U.S. companies controlled by foreign interests has increased the likelihood that foreign governments may take retaliatory action. This may result in legislation in foreign jurisdictions, or the way foreign tax authorities deal with the subsidiaries of U.S. companies. U.K.-based multinationals have voiced concerns to the Inland Revenue and the Parliament in connection with U.S. proposed legislation and regulations which impact their U.S. operations.

Against this background, the Administration has proposed additional new proposals which we believe are misdirected and would be at cross-purposes with the President's articulated broad policy goals.

III. ADMINISTRATION PROPOSALS

The Foreign-Based Corporation Action Group is very concerned with several provisions included in the Administration's tax package which appear to be directed at foreign-owned U.S. companies. Perhaps more troubling, these tax provisions would exacerbate a disturbing U.S. tax policy trend in recent years to treat foreign-owned U.S. companies as second-class citizens and to single them out for discriminatory treatment. We believe that this tax policy trend is extremely short-sighted as foreign-owned U.S. companies make an invaluable contribution to the U.S. economy and living standard.

Earnings stripping guarantees

The Administration has proposed amending section 163(j) of the Code to include within the definition of related party debt any loan from an unrelated party that is guaranteed by a related party. Other provisions would be adopted to prevent the use of back-to-back loans and other similar arrangements.

The Foreign-Based Corporation Action Group believes that section 163(j) is discriminatory and consequently contravenes our income tax treaties, which provide that the treaty partners will not treat foreign-owned capital less favorably than locally-owned capital. The earnings stripping rules are discriminatory, and are squarely inconsistent with the obligation of the United States to treat subsidiaries of foreign companies fairly.

The extension of section 163(j) to guaranteed debt and, in some unspecified way, to back-to-back loans in general, is in our view more clearly discriminatory against foreign-owned corporations than original earnings stripping legislation enacted in 1989. It is hard to imagine a situation in which the guaranteed debt proposal could apply to tax-exempt entities other than foreign persons. Not only would it be unusual for a tax-exempt entity under sections 401 and 501 to lend to a related taxable party, but it would be extraordinary for such an entity to guarantee a loan of a related taxable party. An analysis of the revenue estimates for this provision will surely confirm that all additional revenues will come from foreign-owned and not U.S.-owned domestic corporations. Legislation which so clearly violates our non-discrimination clauses in tax treaties could result in retaliatory legislation; it would not be difficult for U.S. treaty partners to revise their thin capitalization regulations in response to U.S. legislation.

Another aspect of this proposal is that it is bad tax policy to treat loans from U.S. lenders such as U.S. banks as subject to the extension. In this situation, the interest is subject to U.S. tax in the hands of the lender so that there is no possible earnings stripping activity.

We strongly believe that any legislation in this area should not apply to loans made before the date of Committee action. The effective date of the proposal (interest paid in taxable years beginning after December 31, 1993) is in effect retroactive, in that it contravenes the 1989 legislative history, which very clearly made a commitment to make any new regulations applicable to new debt issued after that date. That this proposal is technically new legislation and therefore sets its own effective dates does not alter the fact that a commitment was made under the 1989 legislation and taxpayers were led to believe that they could rely upon it. The practical result of making a legislation apply to existing debt is that existing loans (from unrelated parties) will have to be renegotiated. Since this would apply to bonds and commercial paper, this has the potential for disrupting the financial markets.

We also believe that this issue should be dealt with by regulation, as originally contemplated by Congress in 1989 when section 163(j) was enacted. Specifically, the Committee report on section 163(j) stated that "The conferees intend to clarify that the provision is not to be interpreted generally to subject third-party interest to disallowance under the rule whenever such a guarantee is given in the ordinary course". The report goes on to state that the rules could be applied to "guaranteed third-party debt in appropriate circumstances where the use of guaranteed third-party debt is a device for avoiding the operation of the earnings stripping rules". It appears that the proposed legislation abandons the "in appropriate circumstances" idea in favor of applying to all loan guarantees regardless of the circumstances.

We believe that regulations could be promulgated under section 163(j) which would distinguish between guarantees in the ordinary course of business and thin capitalization issues. Clearly, tax policy would be better served by completing these regulations than by enacting additional legislation in this complex area.

Transfer pricing initiative

We would like to turn to the Administration's proposal relating to intercompany pricing. On January 13, 1993, the Internal Revenue Service released temporary section 482 regulations replacing current rules and terminology applicable to intercompany pricing in transfers of intangibles and modifying current rules with respect to tangible property, but affirming the use of the arm's-length principle.

In addition, the regulations describe three proposed profit split methods and provide that other profit split methods may be used. The proposed penalty regulations, sections 6662(e) and 6662(h), call for strict penalties in the case of substantial and gross valuation misstatements in transfer pricing.

The Administration's proposal relating to transfer pricing defines the reasonable cause and good faith exclusion to the 6662(e) penalties so that the clause will apply only if contemporaneous documentation demonstrating the application of taxpayer methods is provided to the Service. Thus, the Administration would codify the proposed penalty regulations. These penalty regulations define a two-prong approach to the definition of the reasonable cause and good faith exclusion: that the taxpayer show "reasonable effort" in determining proper tax liability through contemporaneous documentation, and that the taxpayer show "reasonable belief" in their transfer pricing method based on the experience and knowledge of the taxpayer.

One discrepancy between the Administration's initiative and the proposed penalty regulations arises from the use of "other" methods for determining arm's-length pricing for intangible and tangible transfers. The proposed regulations state that "reasonable belief" can be satisfied with the use of one of the prescribed methods in the section 482 regulations, but that the use of "other" (undefined in the regulations) methods will not satisfy the requirement. The Administration's proposal states that "other" methods may be included for purposes of the clause if "the taxpayer could establish that, at the time of the controlled transactions, the prescribed methods would not be likely to lead to an arm's-length result, and that the method actually applied was likely to lead to such a result." This statement in the proposal seems to override the "best method" rule of the temporary section 482 regulations which replaced a priority of methods in an earlier draft of the regulations. According to the best method rule, taxpayers should be obliged only to prove that the chosen method provides an arm's-length result, not to disprove discarded methods.

The codification of the penalty regulations would be supplemented with a transfer pricing enforcement initiative, in an effort to collect what some believe is billions of dollars in tax liability that foreign-owned U.S. firms avoid paying through transfer pricing violations. In testimony last year before the Oversight Subcommittee then IRS Commissioner Shirley Peterson noted that the conclusion that foreign-owned U.S. companies are using transfer prices to avoid paying their fair share of U.S. taxes cannot be substantiated. In addition, the amount of revenue to be collected by the enforcement of transfer pricing regulations has been grossly overstated in the past. The Clinton campaign first estimated that controlling transfer pricing abuses would raise $45 billion, then revised that number to $3.8 billion in the current proposal; the Joint Committee on Taxation has since revised the Administration's estimate downward to $250 million. We believe that any additional transfer pricing enforcement should apply even-handedly to both inbound and outbound companies.

The belief held by many legislators that transfer pricing abuses account for significant revenue loss to the United States has led to a number of legislative and administrative efforts over the past few years. New temporary section 482 regulations, increased record-keeping requirements under 6038A, and proposed transfer pricing penalties under sections 6662(e) and 6662(h) have been introduced to address these perceived transfer pricing abuses. It should be noted that the documentation requirements and other criteria on intercompany pricing are far greater in the U.S. than in any of the countries with which the United States has entered into international tax treaties.

In conclusion, at a time when international cooperation, rather than contention, is necessary to revitalize the international economy, it seems unwise for the U.S. to be considering tax law changes that would cause so much potential ill will abroad. We do not believe the small amount of revenue raised warrants the international disturbances that would ensue from these proposals.

ERIC R. FOX
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March 12, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

In accordance with the Press Release issued February 26, 1993, by the Honorable Dan Rostenkowski, the undersigned is submitting this written statement for the printed record of the hearings to be held on March 9, 10, 16, 17 and 23, 1993, before the Committee on Ways and Means in connection with the Clinton proposals for public investment and deficit reduction.

The Administration consistently takes the position that taxes on the wealthiest Americans must be increased to make the tax system fairer. The Administration's proposals, however, have nothing to do with fairness and everything to do with demagoguery. If the Administration's proposals are adopted, taxes on the wealthiest Americans will have increased by more than 50% since 1990. Even if one could establish that the 28% rate was too low, a highly debatable point, given the fact that in enacting this rate, Congress essentially eliminated miscellaneous deductions, non-mortgage interest deductions and passive loss deductions, an increase in the tax rate of more than 50% in two years goes outrageously far beyond any reasonable adjustment.

This 50% increase is not hyperbole. Prior to 1990, the top tax rate was 28%. The Administration now proposes to increase that rate to 36%. With the 3% floor on itemized deductions, the rate is really 37%. Adding a 10% surcharge takes that rate over 40%, and uncapping the Medicare tax adds yet another 3% to those of us who are both employer and employee.

Not to be lost sight of is the fact that, in 1990, the top 10% of income earners paid 53.9% of Federal income tax whereas they only paid 48.6% of such taxes in 1980. The lowest 50% of income earners had their share of the income tax burden reduced from 7.4% to 6.2% in the same ten years.

In short, the "fairness issue" is a total phony.

Very truly yours,

Eric R. Fox

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GAS PROCESSORS ASSOCIATION

POSITION ON BTU TAX

The gas Processors Association (GPA) is comprised of approximately 160 member companies. These GPA member companies operate approximately 700 natural gas processing plants, producing about 90% of all natural gas liquids produced in the United States.

GPA membership includes most of the major oil and gas companies, as well as a number of international companies. However, about 75% of the GPA members in the U.S. are small-to-medium sized independent, nonintegrated producers and processors of natural gas and natural gas liquids. Nearly 40% of the nation's 734 gas processing plants are operated by these independents, and nearly three-fourths of all processing plants are small facilities processing less than 50 million cubic feet of gas per day.

The gas processing industry is a major segment of the oil and gas industry, distinct from either crude oil or natural gas production, separate from oil refining or gas distribution, yet indispensable to all. As a separate and identifiable function, it is probably the least known part of the petroleum industry. Whether or not the gas processing function is understood, even in the petroleum industry, gas plant production provides about 18% of total U.S. petroleum liquids production.

While the GPA is generally opposed to further energy taxes, the following suggestions are offered concerning the pending BTU tax.

NATURAL GAS

A tax on natural gas should be levied downstream of the gas processing plants at, or close to, the ultimate point of consumption as fuel where its final use is known. A tax upstream of the gas plant, particularly at the wellhead, would introduce many complications, including the possibility of double taxation in the case of natural gas liquids (NGLs), which have not been removed from the gas at this point. In addition, it would be difficult if not impossible for the owner of gas to pass the tax on to the purchasers, as the price for gas is market-driven. Should producers have to absorb the tax, the result would be decreased

natural gas production as existing wells would be shut in and drilling would be slowed even further than is now the case. Unless the tax is felt by the consumer, the desired result of conservation will not be achieved by the tax.

In addition, the GPA believes that taxes on some uses would be inconsistent with the intent of the proposed legislation. The use of fuel for the production, processing, and transportation of natural gas should be exempted from the tax in order to encourage the production and use of the cleanest fuel available to the market. As natural gas use is encouraged by the administration, likewise production of the fuel should be encouraged, rather than further costs being placed upon its production. In addition, natural gas used as chemical feedstocks and those volumes exported should be exempted from the tax.

NATURAL GAS LIQUIDS

Natural gas liquids (NGLs) are a very important portion of the energy picture in the U.S. Approximately 75% of the NGLs produced in the U.S. is from gas processing plants and about 25% is from refineries. Used primarily as petrochemical feedstocks and motor gasoline feedstocks as well as directly as fuels, these products cover a large spectrum of uses. In fact, 1991 industry data show that only about 24% of the NGLs consumed in the U.S. are used directly as fuels.

The primary NGLs are ethane, propane, butanes, and natural gasoline. The majority of NGLs are used as feedstocks to create other products. Ethane is used almost exclusively as a petrochemical feedstock in the manufacturing of plastics. Butanes are utilized primarily for both petrochemical feedstocks and as feedstocks in the manufacturing of motor gasoline. Only a small percentage (6.5%) of butanes is used directly as fuel. Natural gasoline is also used as a petrochemical and motor gasoline feedstock, and is seldom, if ever, used directly as fuel. Propane is the only natural gas liquid which is used substantially as a direct fuel, although a very significant portion is also utilized as a feedstock.

As GPA understands the tax proposal, feedstocks would be exempt. Approximately 48% of NGLs are used as chemical feedstocks. Another 21% of NGLs are used in the manufacturing of motor gasoline, a product which will already be taxed. The taxation of NGLs prior to their use as feedstocks or in the manufacturing of motor gasoline would cause double taxation and/or the necessity of burdensome and potentially inequitable refund procedures where the party paying the tax may not be the party which is eligible to collect the refund.

Therefore, GPA proposes that all NGLs be exempted from the Btu tax except for those which are odorized for use directly as fuel. The odorized LPG (propane and butane) used as fuel should be taxed at the natural gas rate at the point of odorization. The owner of the LPG at the time of odorization or the time of import of odorized LPG should make the assessment on the volume of LPG sold and placed into commerce. This particular process has worked well in the Texas LP Gas check-off program and is being proposed for a national check-off program. Several ends would be achieved by taxing at the point of odorization. Essentially all the NGLs used as fuel are required to be odorized before being placed into commerce. In addition, only those NGLs used as fuel would be taxed, eliminating the need for an involved refund procedure on the majority of the products if all NGLs were taxed and refund procedures had to be established for the majority of the products which are not used as fuel.

In addition, GPA suggests that any LPG used as an alternate fuel should be taxed or exempted in the same manner as all other alternative fuels, including CNG. LPG has been recognized as a clean, viable, alternative fuel for which a distribution infrastructure is in place, making it a valuable addition to the pool of alternative fuels which can significantly reduce the consumption of motor gasoline. Exports of NGLs should be exempted from the tax.

In summary, the natural gas processing industry processes and produces fuels domestically which are environmentally friendly and abundant. Such fuels meet the criteria set forth by the administration to be encouraged for use as fuels, and any energy tax on these fuels should be applied in a fair and efficient manner. Therefore, any tax placed on NGLs should be levied at i) the point where they are odorized for use as a direct fuel or ii) the point where they are sold or used in their final form as fuel such as motor gasoline. Furthermore, for the reasons set forth above, any tax on odorized NGLs used as fuel should be levied at the same rate applied to natural gas.

Respectfully submitted,

Mark F. Sutton
Executive Director

Statement of Thomas M. Bloch
President and Chief Executive Officer of H&R Block
Presented To The
Ways and Means Committee of the
U.S. House of Representatives

EXECUTIVE SUMMARY

1. H&R Block applauds the overall fairness of the economic package proposed by President Clinton and urges the Committee to support this initiative.

2. We support the President's proposed expansion and simplification of the earned income tax credit as an effective means to assist low income families and individuals.

3. We also support the President's initiative to increase progressivity in the tax code, by distributing its burden more fairly throughout all income brackets.

4. H&R Block encourages the Committee to include a children's tax credit, to provide greater fairness for middle income taxpayers.

As President and Chief Executive Officer of H&R Block, Inc. I appreciate the opportunity to present H&R Block's views to the House Ways and Means Committee on President Clinton's tax package.

H&R Block is headquartered in Kansas City, Missouri, and is the nation's largest income tax return preparation service. We have 9,511 company-owned and franchise offices worldwide employing over 89,000 people during the tax filing season. Last year, we prepared 12% of all individual U.S. income tax returns for a total of over 12 million returns. In addition to our U.S. operation, we have offices in Canada and 13 countries overseas.

We have been serving America's taxpayers since 1955 when my father, Henry Bloch, and his brother founded the company. The vast majority of our customers are middle and lower income taxpayers. We have more experience working with and listening to middle and low income taxpayers than any other firm. As a result, we are in a unique position to learn of the particular problems and concerns faced by America's taxpayers.

THE PRESIDENT'S TAX PACKAGE MAKES THE FEDERAL TAX SYSTEM MORE FAIR

I would like to commend President Clinton on the tax package he has introduced. In particular, I believe that the President's proposals to expand and simplify the earned income tax credit (EITC) and raise tax rates on wealthy taxpayers will go far to improve the fairness of our tax system.

In the past decade, there has been a growing sentiment among our customers that they are not being treated fairly by the federal tax code. They believe, and studies by our firm as well as others confirm, that the wealthy received substantial tax cuts in the 1980s while middle income taxpayers saw their federal taxes go up. They point to the elimination of the deductions for personal interest and sales tax, as well as limits on deductions for IRA contributions, medical and job related expenses, as contributing to this burden.

H&R Block commissioned an independent study, which was released in April 1992, to investigate the shifting of the

tax burden onto middle and low income taxpayers. Our findings showed significant reductions in total tax rates for the well-to-do matched by substantial increases for middle class taxpayers. This negative impact on middle and low income taxpayers was attributable, in part, to the increased FICA tax rates. Therefore, President Clinton's proposal to repeal the medicare earnings ceiling helps to make the total tax rates more fair. A summary of our study is attached to my testimony.

On behalf of H&R Block, I urge Congress to support the President by implementing his tax package, specifically, his initiatives to expand and simplify the earned income tax credit and to raise tax rates on upper income taxpayers.

THE EARNED INCOME TAX CREDIT SHOULD BE EXPANDED AND SIMPLIFIED

Expansion and simplification of the earned income tax credit as proposed by President Clinton is an extremely effective way for the Federal Government to increase equity in the tax code and provide much needed relief for hardworking low income taxpayers. By expanding the earned income tax credit as the President has proposed, the government would simultaneously create a greater incentive for people to work and would lift more families above the poverty threshold. Extending the credit to low income single taxpayers for the first time recognizes the burden that taxes pose to all taxpayers at the lowest income levels. In addition, expanding the EIC will be important in offsetting the effects of the broad-based energy tax, which would otherwise increase the tax burden on low and middle income taxpayers.

We also support the President's commitment to simplification of the earned income tax credit, now a complex two page form. Some lower income individuals who are currently eligible to receive the credit are either unaware of it or misunderstand it. In some cases, there is even a fear that claiming the EIC will result in a loss of other forms of public assistance. H&R Block recommends that Congress enact an expanded and simplified EITC program because, based on our experience, we believe that this type of tax relief package will benefit the largest number of low income wage earning Americans.

MIDDLE CLASS TAX RELIEF STILL NEEDED

However, we would encourage the Committee to include a children's tax credit, as well. We believe that providing a children's tax credit, similar to those proposed by President Clinton during the campaign and by various members of the 102nd Congress, could provide middle income families some of the relief that the earned income tax credit provides for low income families. H.R. 2242 and S. 995, the Working Family Tax Relief Act introduced by former Rep. Tom Downey (D-NY) and by Vice President Al Gore (D-TN) in the last Congress included the kind of children's tax credit that we believe should be considered. A different approach is the proposed legislation by Sen. Coats (R-IN) S. 474 which would increase the amount of the exemption for dependent children. Whichever of the various approaches the Committee favors, we believe tax relief for middle income families with children is a key element of improving the fairness of the federal tax system. Even if you conclude that middle income tax relief is not needed to stimulate the economy, it is still needed to restore equity.

RESULTS OF LAST YEAR'S CHANGE IN THE WITHHOLDING TABLES

In my testimony before the House Ways and Means Committee last year, I predicted then that President Bush's change in the federal withholding tables -- lowering the withholding rates in 1992 so taxpayers would receive more in their paychecks -- would frustrate, disappoint and shock many taxpayers expecting refunds this year. And indeed it has. This decision also created needless complexity for taxpayers, who have had to file new W-4s to get the same amount of refund or avoid a balance due. We know that taxpayers have had the choice over the years to file new W-4s to have less withheld -- the fact is most didn't do it. Now, many of those same taxpayers who accepted the current system, are being forced to take steps to ensure that they receive the refund amount they desire or to avoid owing an additional amount of tax when they file their return next year.

This year, we are finding many taxpayers are filing their returns later than usual due to this reduction in withholding. In addition to affecting the filing pattern, you should be aware of the potential compliance problems that could be created by reducing, and in some cases eliminating, taxpayers' refunds. If, for example, certain taxpayers expect to owe taxes, instead of receiving a refund, they may be less inclined to file tax returns. Consequently, the IRS could have their workload increased because they may have to identify and locate these nonfilers. This is a very real possibility which can create unanticipated problems and an additional burden for the IRS.

CONCLUSION

H&R Block is pleased that the Administration and the Congress are working to distribute the income tax burden in a more equitable way for all Americans. Specifically, we recommend that Congress implement the President's proposal to expand and simplify the earned income tax credit and include a children's tax credit to provide relief to the greatest number of middle and lower income taxpayers. Furthermore, we support measures to create more equitable rates for taxpayers in the highest income brackets.

Finally, H&R Block would be happy to provide any assistance, in particular, as you consider simplification of EITC and the possible inclusion of a children's tax credit. As I stated earlier, we have more experience with middle to low income taxpayers than any other firm and naturally have extensive expertise and information we can offer to assist the House Ways and Means Committee.

The Shift in Federal Tax Burden onto the Middle Class

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Executive Summary

American citizens are aware of the on-going debate regarding middle class tax cuts, but are not likely to find the results of econometric studies which focus on methodological nuances relevant to their individual economies. The approach undertaken in this study is centered on describing the tax burden imposed by those tax provisions readily perceived to affect taxpayers directly - i.e., personal federal income tax and employee contributions to social security. Therefore, to investigate the distributional equity of the federal tax burden across various income levels, illustrative cases are utilized to determine the effective tax rates experienced by US taxpayers filing as single, married joint, and head of household.

The ultimate objective of this study is to produce a resource from which taxpayers may judge for themselves (1) the impact of specific tax provisions on the taxes they pay in relation to other taxpayers within their income class (horizontally) and taxpayers across income classes (vertically); and, (2) how their relative positioning has changed over the course of the last fifteen years.

Trends in the effective rate of taxation on American taxpayers were determined through the development and analysis of thirty-two (32) illustrative cases. Four distinct filing statuses were employed in the study and are presented in Table E-1 with the number of dependents assigned to each.

Table E-1. Types of Filing Status and Assumptions Used in Illustrative Cases.

Filing Status	Number of Exemptions
Single Filer	1
Head of Household, 1 Dependent	2
Married Filing Joint, No Dependents	2
Married Filing Joint, 2 Dependents	4

For each type of taxpayer shown in Table E-1, eight income groups were selected to represent the range of income distribution in the United States from the lower end of the middle class to that representing wealthy persons. Table E-2 presents the various income groups for the four tax years of interest to this study; namely, 1977, 1984, 1988, and 1990. The income levels shown represent adjusted gross income.

Table E-2.	Income Groups for Each Tax Year and the Treatment of Deductions.			
Income Group	**Type of Deduction**	**Adjusted Gross Income, Nominal Year $**		
		1977	**1984**	**1988**	**1990**

Income Group	Type of Deduction	1977	1984	1988	1990
I	Standard	$ 7,250	$ 11,920	$ 13,580	$ 15,000
II	Standard	12,090	19,870	22,630	25,000
III	Standard	16,920	27,820	31,680	35,000
IV	Itemized	24,180	39,750	45,260	50,000
V	Itemized	36,270	59,620	67,880	75,000
VI	Itemized	48,360	79,500	90,510	100,000
VII	Itemized	72,530	119,240	135,770	150,000
VIII	Itemized	96,710	158,990	181,030	200,000

The overall shift in federal tax burden may be described by changes in effective federal tax rates on taxpayers within varying income groups. Several trends in effective tax rates are described by the findings of this study:

- The percentage change in the effective income tax rates and effective total (income tax and social security) tax rates showed the taxpayers reporting $100,000 or more had a large percentage decrease in tax rates from 1977 to 1990 while rates for the middle income taxpayers rose (see Figures E-1 and E-2).

  EXAMPLE: Taxpayers earning $50,000 (in 1990 dollars) from 1977 to 1990 showed an average percentage *increase* in total tax rates of over 7 3/4 percent for the four filing statuses. Taxpayers earning $200,000 from 1977 to 1990 showed an average percentage *decrease* in total tax rates of over 27 3/4 percent for the four filing statuses.

- The overall trend in federal income tax has been to flatten its rate structure across income levels. The difference between the effective income tax rate for the wealthiest income group ($200,000 in 1990 dollars) and the median income group ($35,000 in 1990 dollars) in 1990 was half that in 1977.

  EXAMPLE: In 1977, a married taxpayer filing a joint return with two dependents earning $35,000 (in 1990 dollars) had an effective income tax rate of 10.64 percent. A married taxpayer filing a joint return with two dependents earning $200,000 had an effective income tax rate of 29.30 percent, or a difference of 18.66 percent. In 1990, a married taxpayer filing a joint return with two dependents earning $35,000 had an effective income tax rate of 9.16 percent. A married taxpayer filing a joint return with two dependents earning $200,000 had an effective income tax rate of 20.98 percent, or a difference of 11.92 percent.

- In conjunction with the lessening progressivity of the tax rate schedule, the middle income taxpayers suffered effective total tax increases due to the increased FICA effective tax rates from 1977 to 1990 (see Figures E-3 and E-4).

- The percentage changes for married filing joint with no dependents or two dependents showed an increase in effective total tax rates through the middle income groups (see Figure E-2).

  EXAMPLE: A married taxpayer filing a joint return with two dependents earning $50,000 (in 1990 dollars) from 1977 to 1990 had a 5.26 percent *increase* in total taxes. During the same time period, a married taxpayer filing a joint return with two dependents with adjusted gross income of $200,000 had a greater than a 24.29 percent *decrease* in total tax liability.

  EXAMPLE: Using 1990 dollars, a married taxpayer filing a joint return with two dependents earning $50,000 from 1977 to 1990 had an *increase* of $4,649 in total taxes. During the same time period, a married taxpayer filing a joint return with two dependents with adjusted gross income of $200,000 had a *decrease* in total tax liability of $16,583.

- The changes in effective tax rates from 1988 to 1990 reflect the implementation of the general tax increases of the Tax Reform Act of 1986. However, the middle income taxpayers experienced a larger increase in taxes than did the lower or higher income taxpayers.

  EXAMPLE: A married taxpayer filing a joint return with two dependents with earnings of $75,000 (in 1990 dollars) had a percentage increase of 4.18 percent in total tax rates from 1988 to 1990. A married taxpayer filing a joint return with two dependents with earnings of $200,000 had a percentage increase of 2.4 percent from 1988 to 1990.

- Uniform tax rate adjustments have not occurred across all income classes.

  EXAMPLE: In 1990, the difference in effective total tax rates between single taxpayers and married taxpayers filing a joint return with two dependents earning $35,000 (in 1990 dollars) was 7.3 percent. The difference in effective tax rates between single taxpayers and married taxpayers filing a joint return with two dependents earning $200,000 was 1.5 percent. In 1977, these same differences between filing statuses at the same earnings levels were 7.3 percent for $35,000 incomes and 7.0 percent for $200,000 incomes.

- Changes in the standard deduction allowances for head of household filers assisted in reducing their effective federal income and total tax rates between 1977 and 1990.

- A much larger portion of the middle income taxpayers are subjected to the maximum FICA tax rate due to the increase in the FICA earnings cap to 145 percent ($51,300/$35,353) of the median income amount in 1990 as compared to only 103 percent ($16,500/16,009) of the median income amount in 1977 (see Figures E-5 and E-6).

The impact of flattening the federal income tax structure, i.e., the loss of federal revenues, was countermanded by the increased rate of FICA taxation. The result

has been a tax savings for the wealthy while increasing the amount of federal tax paid by middle class taxpayers.

Figure E-1

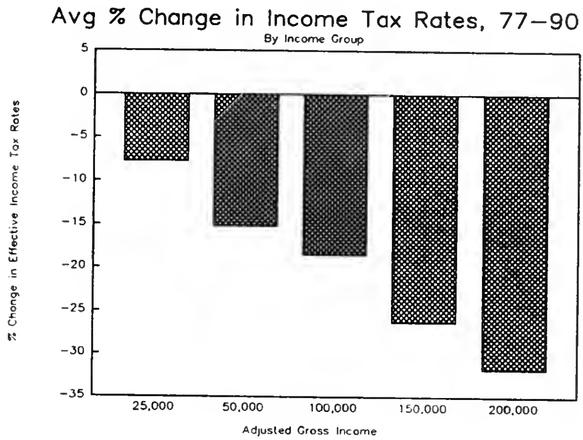


Figure E-2

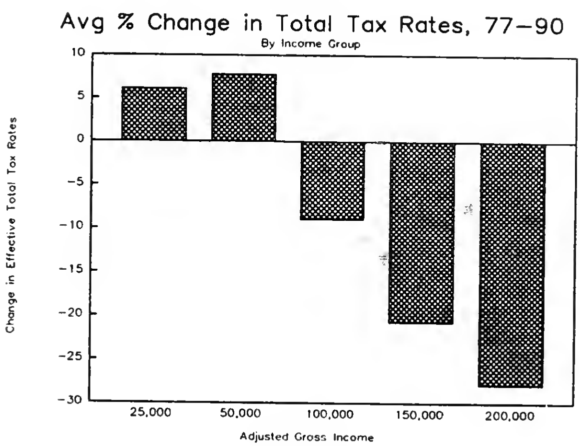


Figure E-3

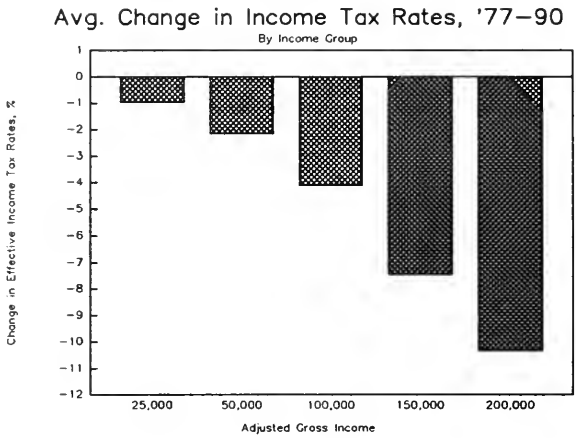


Figure E-4

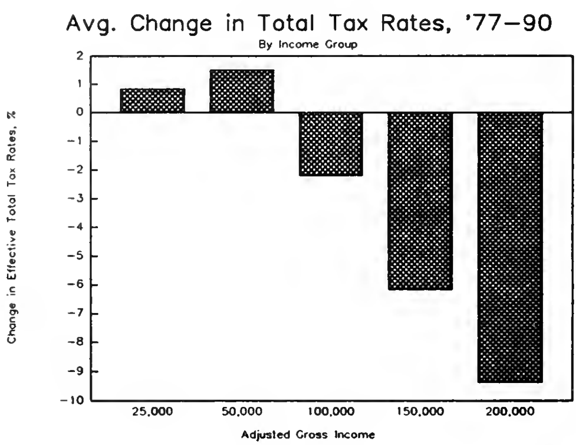


Figure E-5

Difference In FICA Earnings Cap and the Median Income Level by Tax Year

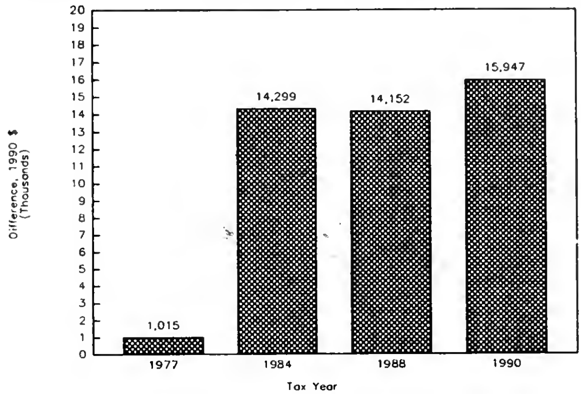
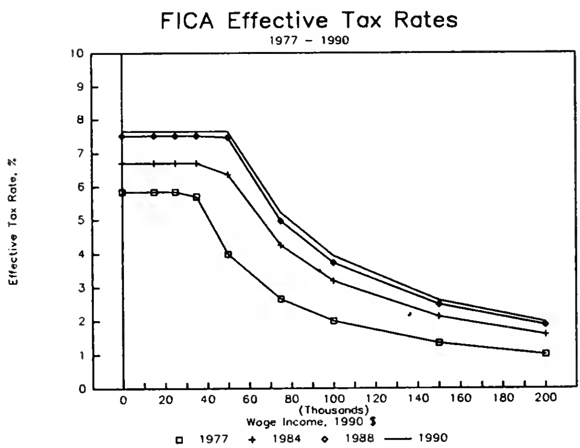


Figure E-6



Managing the Maturity Structure of Treasury Debt and The Role of Floating-Rate Treasury Bonds

CAMPBELL R. HARVEY

Today's adjustable-rate mortgages are much cheaper than their fixed-rate counterparts – more than 2% cheaper. With today's interest rate environment, it makes sense for the Treasury to consider issuing some adjustable-rate (or floating-rate) bonds. The interest cost of these bonds is sharply lower than fixed-rate coupon bonds. In addition to reducing the cost of servicing the government's debt, this policy will reduce long-term interest rates.

Indeed, this idea has been proven to be a winner in the corporate world. In the Eurobond market, there is a large supply (over $100 billion) of floating-rate corporate bonds. The coupon adjusts according to a formula that is based on interest rates on Certificates of Deposit (in U.S. dollars) in London banks. Investment banks also earn profits by purchasing U.S. Treasuries and transforming them into floating-rate bonds. The Treasury could easily bypass the middleperson and issue their own floating rate bonds.

Effect on long-term rates

The overwhelming economic goal is accelerate job creation and economic growth without sparking inflation. While considerable previous attention has been focussed on lowering short-term rates, most of the economic kick comes from long-term rates. Capital investment, consumer credit and mortgage rates are all closely linked to long-term rates – not short-term rates. Any plan that reduces long-term rates will increase investment, spending, housing starts and employment.

Indeed, we have seen long-term rates drop almost a full percentage point in the last four months. This is encouraging. However, long-term interest rates are still almost 4% higher than short-term rates. This huge spread is virtually unprecedented over the past 35 years.

There are a number of forces that affect long-term interest rates. Two of the most important forces are the supply of bonds and the market expectations of long-term inflation.

As a result, one way to lower long-term rates is to reduce the immense burden of long-term bonds in the market. As the supply is reduced, bond prices rise and interest rates fall. A reduction in the deficit will lessen the pressure on the

long-term bond market and reduce rates. Another option is to shorten the maturity structure of the bond offerings, i.e. offer more short-term debt and less long-term debt. This would decrease long-term rates and increase short-term rates.

There is another possibility that would be successful that has received no attention: The floating-rate bond scenario. Currently, the Treasury is issuing 30-year bonds with an effective yield of about 6.8%. If the Treasury issued a 30-year floating-rate bond (with a coupon rate that changes as short-term interest rates change), they could save at least 300 basis points (3%) in interest servicing costs in the first year. With an estimated $1.41 trillion of debt hitting the market in 1993, the interest savings would be impressive if some floating-rate debt was issued.

The introduction of floating-rate bonds will diminish the supply of the long-term fixed rate bonds and hence long-term interest rates will decrease. Lower rates reduce the interest servicing cost of new long-term fixed-rate debt. In addition, the lower long-term rates provide an environment which encourages capital investment, spending and construction.

Specifics of the coupon adjustment

I envision the floating coupon being determined by the weighted average of the 26-week Treasury bill auction yields over the previous six months. Given that this market is extremely liquid, it is unlikely that any one investor could manipulate the coupon rate. The weighting ensures that smaller auctions receive a lesser weight in determining the coupon rate.

This coupon setting strategy also dominates the inflation-indexed coupon. Last year there was some discussion of creating a *real bond*. The bond is real in the sense that the coupon increases as inflation increases and this allows investors to hedge against price inflation.

Unfortunately, the inflation rate is imprecisely measured and usually five weeks stale when it is released. As a result, a lot of people know the numbers before the official release date. In addition, the index numbers are subject to revision. Finally, the items that we include in the consumer's basket could change over time.

Resetting the coupon based on the Treasury bill auction bypasses all of the inflation-related difficulties. It creates a bond which has real qualities: as inflation increases so will short-term interest

rates and hence the coupon rises on the floating-rate bond. Investors can use the floating-rate bond as an inflation hedge. In addition, the information on the coupon reset is easily calculated and readily available to all investors.

Expected inflation and interest rates

The other important factor that determines long-term interest rates is expected inflation. Indeed, the present yield curve (difference between long-term rates and short-term rates) suggests that investors expect increased inflation in the future. The fact that the Treasury is offering 30-year bonds at 6.8% suggests that the Treasury agrees with the market!

If the Treasury really believes that inflation is going to be lower in the long term, then it does not make sense to finance at 6.8%. If the Treasury believes that the market is attaching an unreasonably high inflation premium to the long-term bonds, then it should pursue a strategy of shorter-maturity financing – or floating-rate bonds.

Adopting a policy of floating-rate bonds or shortening the maturity structure, sends a strong signal to the market that that investors' long-term inflation expectations are too high. I believe that initiating this policy would cause the market to revise their long-term inflation expectations and reduce long-term interest rates by another 1% – irrespective of the supply effect previously discussed.

There is another important angle on the floating-rate and shorter maturity financing: It provides the incentives for the government to be *policy consistent*. That is, a deviation from the policy of low inflation will be very costly. Higher inflation immediately raises short-term rates and, consequently, the Treasury must pay more in financing costs. Investors like these types of policies. There are strong built-in incentives to keep inflation under control. These are the types of policies that cause investors to revise their expectations of long-term inflation downward, thereby reducing long-term interest rates.

Finally, it is an *automatic stabilizing policy*. During the last five recessions, the yield curve has been positively sloping[1] (short-term rates lower than long-term rates). The interest servicing cost on floating-rate debt is cheapest exactly when the government needs extra funds for stimulative expenditures.

Floating-Rate Bonds vs. Operation Twist

The floating-rate bond offers a number of advantages over the strategy of shortening the maturity structure of the Federal debt, also known as *Operation Twist*. Operation Twist refers to the strategy followed by the Federal Reserve in 1961. The Fed purchased long-term bonds and sold short-maturity securities. This reduced the supply of the long-term bonds and thereby raised their prices. Higher prices for the long-term bonds meant lower yields. The opposite happened with the short-term securities.

Operation Twist was designed to *twist* the yield curve. The objectives were to decrease long-term rates, to support the dollar and to provide the conditions for accelerated economic growth.

Of course, if the Federal Reserve mounted the same strategy today, it would surely fail. With over $4 trillion in Treasury debt outstanding, the Federal Reserve is not a large enough player in the market to substantially impact the yield curve. However, it is possible that the Treasury could successfully initiate a modern-day Operation Twist.

Managing the maturity structure will have a significant effect on the shape of the yield curve. Last summer, when long-term rates were more than 4% above short-term rates, I suggested that the Treasury consider a shift in the maturity structure.[2] By decreasing the reliance on (but not eliminating) the long-term bonds and replacing them with short-term bonds, I estimated that the Treasury could save over $5 billion in interest servicing costs.

Downside of Operation Twist

There is an important downside to Operation Twist. A shortening of the maturity structure will likely increase short-term rates. Increased supply of shorter maturity debt will drive prices down and yields upward.

Another disadvantage is that the Treasury must continually go to the market. That is, if a 30-year bond is replaced with 90-day bills, the Treasury must issue those bills 120 times. The Treasury bears the cost of going to the market each time. In addition, the investor must bear the transactions costs of rolling over the Treasury bills.

One possible solution is to combine a shortening of the maturity structure with some floating-rate bonds. The floating-rate bonds reduce long-term rates because the supply of long-term bonds is decreased. It is not clear that there would be

the same upward pressure on short-term rates.

With floating rate bonds, you are not replacing long-term bonds with Treasury bills. The amount of Treasury bills could remain constant. However, some of the current Treasury bill investors might be drawn to the floating-rate bonds. This might provide some mild upward pressure on short-term rates.

Conclusions

The changes in the Treasury's financing strategy that I am proposing should lead to a further reduction in long-term interest rates. The introduction of floating-rate coupon bonds will reduce the burden placed on the long-term fixed coupon bonds and hence reduce the long-term rates. Given that consumer spending, construction and capital expenditures are linked to long-term interest rates, changes in the Treasury's financing strategy will have a stimulative effect on economic growth. In addition, the strategy reduces the government's interest servicing costs.

Of course, variable-rate debt could be expensive if interest rates go up. However, short-term interest rates have to rise dramatically to meet today's long-term rates. In addition, my research on the business cycle and the yield curve shows that the interest servicing costs will be the lowest in recessions and highest in recoveries. As a result, the policy stabilizes or reduces the volatility of the business cycle.

Endnotes

1. See C. R. Harvey, "Restructuring the Federal Debt," Working paper, Duke University, (June 1992) and subsequent coverage C. Stock, "U.S. Treasury Could Save" Knight Ridder, August 18, 1992, D. Kalish, "Here's a Possible Plan for Saving Billions: Finance Professor Offers a Scheme on Treasury Debt," Associated Press, August 24, 1992, "Money Wheel" CNBC, August 4, 1992.

2. My research on the relation between the yield curve and the business cycle is contained in C. R. Harvey, "The Real Term Structure and Consumption Growth," *Journal of Financial Economics* **22** (1988): 305–334, C. R. Harvey, "Forecasting Economic Growth with the Bond and Stock Markets," *Financial Analysts Journal*, September/October (1989): 38–45, C. R. Harvey, "The Term Structure and World Economic Growth," *Journal of Fixed Income* **1** (1991a): 4–17, C. R. Harvey, "Interest Rate Based Forecasts of German Eco-

nomic Growth," *Weltwirtschaftliches Archiv* **127** (1991b): 701–718, C. R. Harvey, "Les Taux d'Intérêt et la Croissance Economique en France," *Analyse Financière* **86** (1991c): 97–103, C. R. Harvey, C. Kirby and S. Kaul, (1992), "La Capacità Previsiva della Struttura per Scadenza dei Tassi d'Interesse Italiani in Relazione alla Crescita Economica Reale," Working paper, Gruppo IMI, and C. R. Harvey, (1993), "The Yield Curve, Stock Returns and the Prediction of Canadian Economic Growth," Working paper, Duke University.

Biography

Campbell R. Harvey is Associate Professor of Finance at Duke University in North Carolina. He received his Ph.D. from the University of Chicago in 1986 and joined the Fuqua School that year. He has held visiting positions at the Helsinki School of Economics, the University of Chicago, and the Stockholm School of Economics (summer 1993).

Harvey's research has generated international attention from both academic researchers and practitioners. His dissertation showed how to extract forecasts of economic growth from various interest rates. These forecasts turned out to be more accurate than commercially available forecasts.

Harvey is the recipient of numerous awards. He is the 1993-94 Batterymarch Fellow. This annual award is given to the person that is most likely to establish a new area of research in finance. In 1990, the R. L. Rosenthal Award for Innovation in Investment Management was given to Harvey. The Association for Investment Management and Research has recently honored Harvey with the Graham and Dodd Scroll in recognition of excellence in financial writing. The American Finance Association awarded Harvey the Smith-Breeden prize for his publication "The World Price of Covariance Risk."

STATEMENT BY

BRIAN O'CONNELL, PRESIDENT, INDEPENDENT SECTOR

My name is Brian O'Connell. I am founding president of INDEPENDENT SECTOR, director emeritus of the National Mental Health Association and have served actively with a number of voluntary organizations. I am presently the chair of the Executive Committee of CIVICUS: World Alliance for Citizen Participation, which provides a meeting ground for voluntary organizations, groups that fund organizations, and for other groups throughout the world who want to find ways to develop greater citizen participation in a growing number of countries. I am also one of five co-chairs of that organization.

INDEPENDENT SECTOR is a nonprofit coalition of 850 corporate, foundation and voluntary organization members with national interest and impact in philanthropy and voluntary action. The organization's mission is to create a national forum capable of encouraging the giving, volunteering and not-for-profit initiative that help all of us better serve people and communities. I attach a list of INDEPENDENT SECTOR'S members.

I will focus my comments on those parts of President Clinton's proposals for public investment and deficit reduction that have direct impact on charitable organizations and people they serve.

Gifts of Appreciated Property

INDEPENDENT SECTOR strongly supports the March 31, 1993, statement of Rear Admiral David M. Cooney, U.S.M. (Ret.) President, and Chief Executive Officer of Goodwill Industries of America, Inc., made on behalf of the Appreciate Property Working Group, in support of the President's proposal which would provide relief from the alternative minimum tax for all gifts of appreciated property. A majority of the Ways and Means Committee supported this change in the last Congress, and we are grateful for that support. We are also grateful for the leadership of Congressman Mike Andrews of Texas and Congressman Clay Shaw of Florida, the sponsors of the legislation.

Gifts of appreciated property are very important sources of funding for a broad array of nonprofit organizations. It is true that groups associated with higher education, the arts, and the environment are often recipients of gifts of appreciated property. It is equally true that YMCAs, the Salvation Army, and virtually every nonprofit that conducts a capital campaign for a new building or a new wing, are recipients of appreciated property gifts. In fact, the lead gift in virtually every capital campaign is a gift of appreciated stock.

Gifts of appreciated property are contributed by upper income individuals and it's important to note that there has been reduction in giving among those contributors since 1986, when gifts of appreciated property were made subject to the alternative minimum tax. Since 1986, average giving by those with incomes of $1 million or more fell from $199,875 to $81,147 in 1989.

Gifts of appreciated property have been characterized by some as a loophole for wealthy contributors. In fact, this is simply not true. Individuals who contribute gifts of appreciated property have less wealth after making the contribution, than before. It is a myth to characterize this deduction as a tax loophole for the wealthy, suggesting that somehow a contributor has more wealth after making the contribution, than before. The reverse is true.

Again, we support the President's proposal and the committee's past actions to make this legislation permanent and to expand it to all gifts of appreciated property.

Proposal to Make Permanent the 3% Floor on Itemized Deductions Including Charitable Deductions.

INDEPENDENT SECTOR supports the elimination of the charitable tax deduction from the 3% floor.

Congress included in its 1990 budget agreement a 3% floor on itemized tax deductions, including charitable deductions, for families with adjusted gross incomes over $100,000. On a number of occasions since that time, the tax writing committees have proposed either to extend the deduction beyond its scheduled expiration date of 1995 or to make it permamemt. Now, President Clinton has proposed making it permanent. It seems

very evident there is little support for permitting the floor to expire in 1995. For that reason, INDEPENDENT SECTOR advocates dropping charitable from the 3% floor to avoid further erosion and possible ultimate loss of the charitable tax deduction. Following are our reasons for that action:

- Eliminating charitable from the 3% floor involves relatively little federal revenue. Of the $2.4 billion in federal revenue raised annually by the 3% floor, only about $200 million, or 8%, comes from the charitable deduction according to research data from the Price Waterhouse/INDEPENDENT SECTOR Charitable Contributions Simulation Model.

- Once a floor is established on a tax deduction, Congress is almost always inclined to increase it. The floor on the medical deduction is a case in point. Over the years, Congress increased the floor on the medical deduction so much that now taxpayers can deduct only half of what they could twenty years ago. Moreover, since 1990, the tax writing committees of Congress have proposed, on six different occasions, either to extend the 3% floor beyond its 1995 expiration date, or to make it permanent.

- The 3% floor places a special burden on charitable contributions. Deductions for state and local taxes, mortgage interest, and charitable contributions are affected by the floor. However, of the three, only the amount given to charitable organizations can be adjusted (that is, reduced) to make up for this increased federal tax.

- The floor is inequitable. It affects taxpayers differently depending on where they live. If a taxpayer has no mortgage and doesn't live in a jurisdiction with state or local income taxes, the three percent floor has to be subtracted entirely from the taxpayer's charitable contributions deduction.

- An estimated $700 million can no longer be deducted by contributors to charity as a result of the 3% floor.

- The passage of the 3% floor in 1990 violated the long-standing tradition of not taxing income voluntarily given to charitable organizations. To continue this unprecedented tax is an unwarranted violation of principles embodied in the tax code since 1917.

- The 3% floor on charitable deductions, enacted in 1990, was the fourth major undercutting by Congress over the past decade of the very organizations to which government is transferring so much responsibility. Following is related information.

  - Between 1982 and 1991, government's allocations to its nonprofit partners to fulfill such public services as job training and maternal and child health, dropped by $37 billion, exclusive of medicare and medicaid, according to research conducted for INDEPENDENT SECTOR by Lester M. Solomon of Johns Hopkins University and Alan J. Abramson of The Urban Institute.

  - During that same period, reductions for all federal human service programs dropped by $119 billion, with the expectation that essential services would be picked up by voluntary organizations.

  - The 1986 Tax Act hurt the voluntary sector more than others because of the elimination of the charitable deduction for those who do not itemize their tax returns, changes in the treatment of gifts of appreciated property, and the direct correlation between lower tax rates and the size of many people's contributions. As we forewarned Congress and the Administration, in the years immediately following 1986, there was a 50% decline in the prior rate of growth of charitable giving growth.

  - On top of the cuts in federal funding for charities, and the loss of charitable tax incentives in 1986, in the fall of 1990 Congress enacted

the 3% floor. The average amount given to charity by individuals fell by 9% between 1989 and 1991. Clearly, the loss of charitable tax incentives contributed to this decline.

It is INDEPENDENT SECTOR's position that money freely given away to serve public purposes shouldn't be taxed. It makes no sense for Congress to tax contributions to groups whose service relates to protection of the environment, health, research, food programs for the homeless, schools and colleges, refugee crisis counseling, youth services, civil rights, hospitals, community and international development, the arts, housing for senior citizens, and the many other activities that enrich our society and protect its people. We urge Congress to eliminate the charitable tax deduction from the 3% floor.

Independent Sector's Position on Other Tax Issues Affecting Charities Which Might Come Before the House Ways & Means Committee

There were a number of provisions affecting charities in HR11 which was successfully vetoed by President Bush last year. We understand that some of those provisions might come up again when the Committee considers President Clinton's proposals, so we would like to comment briefly on them at this time.

New Reporting and Disclosure Requirements for Charities

HR11 required taxpayers to have written confirmation from charities for single gifts of $750 or more. The legislation would also require a charity, where a contribution is made partly in exchange for an item of value, to provide acknowledgements that state both the deductible amount and the amount not deductible. INDEPENDENT SECTOR supports that provision.

HR11 also required charities to furnish "upon request made by an individual at the organization's principal office or certain regional offices" copies of the organization's IRS Form 990 and application for tax exempt status. The organization could charge a reasonable fee for the cost of the reproduction. INDEPENDENT SECTOR supports that provision.

HR11 also would have required charities to disclose, in any advertisement or solicitation, that copies of the organization's 990 form could be obtained directly from the organization for a reasonable fee for reproduction costs. INDEPENDENT SECTOR opposes that provision, but supports requiring an organization to inform its donors of the availability of the 990 form for a reasonable fee.

Corporate Donor Recognition

HR11 provided tax exemption for "qualified public events." This included such events as "thons" (walk-a-thons, bike-a-thons, etc.) if the events are held only once a year, and are the only events of that type, and do not exceed thirty (30) consecutive days. The legislation also exempted public events that are substantially related to the exempt purposes of the organization conducting the events (e.g., symphony concerts, museum exhibits, intercollegiate athletic events, country and agricultural fairs) even if held for more than a thirty (30) day period. Our Members were generally supportive of those provisions, but some Members were opposed to the provision that would have taxed affinity cards (that is, credit cards that contain a charity's name and generate income for the charity) which was the proposed means of raising revenue to pay for some of the exemptions.

Foundation Common Fund

HR11 provided for a "common fund" that would have permitted private and community foundations to pool their investment resources thereby increasing the prospects for a higher rate of return on their investments. INDEPENDENT SECTOR strongly supports that measure.

AAFRC Trust for Philanthropy
AASK America Adopt a Special Kid
ACCESS: Networking in the Public Interest
Accountants for the Public Interest
The Advertising Council
Advocacy Institute
Aetna Foundation
Affiliated Leadership League of and for the Blind of America
African Wildlife Foundation
Aga Khan Foundation U.S.A.
Agricultural Educational Foundation (AEF)
Aid Association for Lutherans
Aid to Artisans
Alcoa Foundation
Horatio Alger Association of Distinguished Americans
Alliance for International Educational and Cultural Exchange
Allied-Signal Foundation
Alzheimer's Association
America the Beautiful Fund
America's Development Foundation
American Arts Alliance
American Association for Higher Education
American Association for Museum Volunteers
American Association for Respiratory Care
American Association for the Advancement of Science
American Association of Colleges of Nursing
American Association of Collegiate Registrars & Admissions Officers
American Association of Community Colleges
American Association of Fund-Raising Counsel
American Association of Museums
American Association of University Women
American Autoimmune Related Diseases Association
American Cancer Society
American Committee on Africa
American Council for the Arts
American Council of Learned Societies
American Council on Alcoholism
American Council on Education
American Craft Council
American Diabetes Association
American Ditchley Foundation
American Express Foundation
American Farmland Trust
American Fisheries Society
American Foundation for AIDS Research
American Foundation for the Blind
American Fund for Dental Health
American Heart Association
American Humane Association
American Humanics
American Indian College Fund
American Indian Graduate Center
American Institute for Cancer Research
American Leadership Forum
American Library Association
American Lung Association
American Museum of Natural History
American ORT Federation
American Public Radio
American Red Cross
American Refugee Committee
American Social Health Association
American Solar Energy Society
American Stock Exchange
American Symphony Orchestra League
American Wildlands
Americans for Indian Opportunity
Amigos de las Americas
Amoco Foundation
Amyotrophic Lateral Sclerosis Association (ALS)
AON Corporation
APPA: The Association of Higher Education Facilities Officers
Apple Computer
The Arc of the United States

Arca Foundation
ARCO Chemical Company
ARCO Foundation
ARCS Foundation
Arizona Community Foundation
ARNOVA-Association for Research on Nonprofit Organizations & Voluntary Action
ARROW
Arthritis Foundation
Arts & Business Council
Aspen Institute
The ASPIRA Association
Associated Grantmakers of Massachusetts
Association for Healthcare Philanthropy
Association for Volunteer Administration
Association of Advanced Rabbinical & Talmudic Schools (AARTS)
Association of America's Public Television Stations
Association of American Universities
Association of American University Presses
Association of Art Museum Directors
Association of Black Foundation Executives
Association of Catholic Colleges and Universities
Association of Episcopal Colleges
Association of Governing Boards of Universities and Colleges
Association of Hispanic Arts
Association of Jesuit Colleges and Universities
Association of Junior Leagues International
Association of Lutheran Development Executives
Association of Performing Arts Presenters
Association of Science Technology Centers
AT&T Foundation
Atlantic Foundation of New York
Mary Reynolds Babcock Foundation
Ball Brothers Foundation
Association of Baltimore Area Grantmakers
Battle Creek Community Foundation
The Bauman Foundation
BellSouth Corporation
Benton Foundation
Alfred Bersted Foundation
The BEST Foundation
Beverly Foundation
Big Brothers/Big Sisters of America
Bing Fund Corp.
Blandin Foundation
Boeing Company
Borden Foundation
Boston College, Social Welfare Research Institute
Boston Foundation
Boy Scouts of America
Boys and Girls Clubs of America
Otto Bremer Foundation
Bridgeport Area Foundation
Bristol-Myers Squibb Foundation
Brother's Brother Foundation
Burlington Resources Foundation
Edyth Bush Charitable Foundation
The Bush Foundation
The Business Enterprise Trust
Patrick and Aimee Butler Foundation
California Association of Nonprofits
California Community Foundation
Camp Fire
Cancer Care
CARE
Carnegie Corporation of New York
The Annie E. Casey Foundation
Catalyst
Caterpillar Foundation
Catholic Charities USA
CBS
Center for Applied Linguistics
Center for Citizen Initiatives
Center for Corporate Public Involvement
Center for Creative Leadership

Center for Creative Management
Center for Foreign Journalists
Center for Non-Profit Corporations
Center for Nonprofit Organization Leadership at Regis College
Center for Policy Alternatives
Center for Research in Ambulatory Health Care Administration
Center for the Study of the Presidency
Center for Women Policy Studies
Center to Prevent Handgun Violence
Challenger Center for Space Science Education
Champion International Corporation
Chase Manhattan Bank, N.A.
The Chevron Companies
The Chicago Community Trust
Chicago Tribune Foundation
Child Care Action Campaign
Child Welfare League of America
Children's Aid International
Children's Fund of Connecticut
Children's Hospice International
Chorus America (APVE)
Christian Blind Mission International
Christian Church Foundation
Christian Management Association
Christmas in April USA
Chrysler Corporation Fund
Church Women United
Citibank
Citizens' Scholarship Foundation of America
Edna McConnell Clark Foundation
The Cleveland Foundation
Close Up Foundation
The Coca-Cola Company
CODEL - Coordination in Development
College and University Personnel Association
College Board
Colonial Williamsburg Foundation
Colorado Association of Nonprofit Organizations
The Colorado Trust
Columbia Foundation
Columbus Foundation
Combined Health Appeal of America
Comerica Incorporated
Commonwealth Fund
Communications Consortium
Compeer
Compton Foundation
Conference of National Park Cooperating Associations
Conference of Southwest Foundations
Congress of National Black Churches
The Conservation Fund
Conservation International
Consortium of Endowed Episcopal Parishes
Continental Corporation Foundation
Coordinating Council for Foundations
Coors Brewing Company
Corning Incorporated Foundation
Coro/Eastern Center
Corporate Citizen
Corporation for Enterprise Development
Council for Advancement and Support of Education
Council for American Private Education
Council for Basic Education
Council for Community-Based Development
Council of Better Business Bureaus/Philanthropic Advisory Service
Council of Energy Resource Tribes
Council of Illinois Nonprofit Organizations (CINO)
Council of Independent Colleges
Council of Jewish Federations
Council of Michigan Foundations
Council on Economic Priorities
Council on Foundations
Council on International and Public Affairs
Cowles Media Company/Cowles Media Foundation

CPC International
Cystic Fibrosis Foundation
Dade Community Foundation
Charles A. Dana Foundation
Dance/USA
Dayton Hudson Foundation
Deafness Research Foundation
Delta Waterfowl Foundation
Denver Foundation
Design Industries Foundation for AIDS
Direct Relief International
Geraldine R. Dodge Foundation
Dole Foundation for Employment of People with Disabilities
Gaylord and Dorothy Donnelley Foundation
R.R. Donnelley & Sons Co.
Donors Forum of Chicago
Donors Forum of Ohio
Donors Forum of Wisconsin
The Dow Chemical Company
Joseph Drown Foundation
Peter F. Drucker Foundation for Nonprofit Management
The Duke Endowment
DuPont
The Durfee Foundation
Dyson Foundation
Earth Share
Eastman Kodak Company
Eaton Corporation
Ecolab
Economic Education for Clergy
Ecumenical Center for Stewardship Studies
Education Commission of the States
EDUCOM - Interuniversity Communications Council
El Pomar Foundation
Elderhostel
Elderworks
Enterprise Foundation
Environmental Defense Fund
Environmental Law Institute
Environmental Support Center
Epilepsy Foundation of America
The Equitable Foundation
Evangelical Council for Financial Accountability (ECFA)
Evangelical Lutheran Church in America
Exxon Corporation
Maurice Falk Medical Fund
Family Service America
Fannie Mae Foundation
Federation of Parents and Friends of Lesbians and Gays
Federation of State Humanities Councils
First Nations Development Institute
First Nonprofit Trust
Father Flanagan's Boys' Home
Fleishhacker Foundation
Florida Association of Nonprofit Organizations
The Ford Foundation
Ford Motor Company Fund
Henry Ford Museum and Greenfield Village
Foreign Policy Association
Forty Plus Educational Center
The Foundation Center
Foundation for Advancements in Science and Education
Foundation for Exceptional Children
Foundation for Global Community
Foundation for Physical Therapy
Foundation for the Carolinas
Foundation for the National Capital Region
Foundation for the Peoples of the South Pacific
The Freedom Forum
The Fresh Air Fund
Frey Foundation
Friends of the National Library of Medicine
The Fuller Foundation
H.B. Fuller Company

The Fund for Dance
The Fund for New Jersey
Fund for Theological Education
GE Foundation
GenCorp Foundation
General Board of Global Ministries, The United Methodist Church
General Conference of Seventh-day Adventists
General Mills Foundation
General Service Foundation
The Wallace Alexander Gerbode Foundation
J. Paul Getty Trust
Gifts in Kind America
Irving S. Gilmore Foundation
Giraffe Project
Girl Scouts of the U.S.A.
Girls Incorporated
Global Fund for Women
Richard & Rhoda Goldman Fund
Morris Goldseker Foundation of Maryland
Goodwill Industries of America
Goodyear Tire & Rubber Company
Edwin Gould Foundation for Children
Grand Metropolitan Food Sector Foundation
Grand Rapids Foundation
Grantmakers in Health
Great Lakes Bancorp
Lucile & Robert H. Gries Charity Fund
Grotto Foundation
GTE Foundation
George Gund Foundation
Alan Guttmacher Institute
Miriam and Peter Haas Fund
Walter and Elise Haas Fund
Evelyn and Walter Haas, Jr. Fund
Habitat for Humanity International
Hallmark Corporate Foundation
Luke B. Hancock Foundation
Mary W. Harriman Foundation
Harris Bank Foundation
Hartford Foundation for Public Giving
Hartford Insurance Group Foundation
Hastings Center
Hawaii Community Foundation
Charles Hayden Foundation
Edward W. Hazen Foundation
Healing Community
William Randolph Hearst Foundations
The William and Flora Hewlett Foundation
High/Scope Educational Research Foundation
Hillhaven Foundation
Conrad N. Hilton Foundation
Hispanic Association on Corporate Responsibility
Hispanic Policy Development Project
Hispanics in Philanthropy
Hitachi Foundation
Hoblitzelle Foundation
Hoffmann-La Roche Foundation
Hogg Foundation for Mental Health
Honeywell Foundation
The Hospital for Special Surgery
Hostelling International American Youth Hostels
Hudson-Webber Foundation
The Huffy Foundation
Human Life International
Hunt Foundation
Huntington's Disease Society of America
Hyams Foundation
IBM Corporation
Illinois Association of Nonprofit Organizations
IMCERA Group
IMPACT II
Independent Charities of America
Independent Research Libraries Association
Indiana Donors Alliance

The Indiana University Center on Philanthropy
Indochina Resource Action Center (IRAC)
Institute for Educational Leadership
Institute for the Future
Institute for Women's Policy Research
Institute of Current World Affairs
Intel Foundation
InterAction (American Council for Voluntary International Action)
Interlochen Center for the Arts
International Aid
International Alliance of Executive and Professional Women
International Alliance of First Night Celebrations
International Association of Psychosocial Rehabilitation Services
International Center for the Disabled
International Child Health Foundation
International Christian Youth Exchange
International Development Conference
International Executive Service Corps
International Paper Company Foundation
International Primate Protection League
International Women's Health Coalition
The James Irvine Foundation
Ittleson Foundation
JCC Association of North America
Jerome Foundation
The Jewett Foundation
JM Foundation
Johnson & Johnson
The Johnson Foundation
Walter S. Johnson Foundation
Christian A. Johnson Endeavor Foundation
Robert Wood Johnson Foundation
Joint Action in Community Service (JACS)
Joint Center for Political and Economic Studies
Josephson Institute of Ethics
Jostens Foundation
The Joyce Foundation
JSJ Foundation
Alexander Julian Foundation
Junior Achievement
Junior Engineering Technical Society (JETS)
Henry J. Kaiser Family Foundation
Kaman Corporation
Kansas Association of Nonprofit Organizations
Ewing Marion Kauffman Foundation
W.K. Kellogg Foundation
Harris and Eliza Kempner Fund
Charles F. Kettering Foundation
Kids Voting USA
Carl B. & Florence E. King Foundation
Kmart Corporation
John S. and James L. Knight Foundation
Kosciuszko Foundation
KPMG Peat Marwick
The Kresge Foundation
Samuel H. Kress Foundation
Albert Kunstadter Family Foundation
Land Stewardship Project
Land Trust Alliance
Laubach Literacy Action
Laurel Foundation
Lawyers' Committee for Civil Rights Under Law
Leadership America
League of Women Voters
Sara Lee Foundation
Leukemia Society of America
Lilly Endowment
Eli Lilly and Company
Lincoln Filene Center
Literacy Volunteers of America
Local Initiatives Support Corporation
The Community Foundation of Greater Lorain County
Los Angeles Women's Foundation
Lubrizol Foundation

George Lucas Educational Foundation
Lupus Foundation
Lutheran Brotherhood Foundation
J. Roderick MacArthur Foundation
John D. and Catherine T. MacArthur Foundation
Make-A-Wish Foundation of America
Mandel Center for Nonprofit Organizations at Case Western Reserve University
March for Life Education & Defense Fund
March of Dimes Birth Defects Foundation
Marin Community Foundation
John and Mary R. Markle Foundation
Marsh & McLennan Companies
Maryland Association of Nonprofit Organizations
MATHCOUNTS/NSPE Education Foundation
Matsushita Electric Corporation of America
Mayo Foundation
McAuley Housing Fund
McConnell Foundation
McCormick Tribune Foundation
McGregor Fund
McKesson Foundation
McKinley Associates
McKnight Foundation
The Meadows Foundation
Medical Education for South African Blacks
Medina Foundation
Richard King Mellon Foundation
Memorial Sloan-Kettering Cancer Center
Community Foundation of Greater Memphis
The Menninger Foundation
The John Merck Fund
Mercy Medical Airlift
Merrill Lynch & Co. Foundation
Metropolitan Association for Philanthropy
Metropolitan Atlanta Community Foundation
Metropolitan Life Foundation
Metropolitan Museum of Art
Mexican American Legal Defense and Educational Fund
Eugene and Agnes E. Meyer Foundation
Michigan Nonprofit Forum
Midwest Center for Nonprofit Leadership L.P. Cookingham Institute
Miles Inc. Foundation
John Milton Society for the Blind
Milwaukee Foundation
The Minneapolis Foundation
Minnesota Council of Nonprofits
Minnesota Mutual Foundation
Mobil Foundation
The Mobile Community Foundation
Monsanto Fund
Mothers Against Drunk Driving
Stewart R. Mott Charitable Trust
Charles Stewart Mott Foundation
Muscular Dystrophy Association
Museum Trustee Association
Muskegon County Community Foundation
Mutual of America Life Insurance Company
Mutual of New York
Myasthenia Gravis Foundation
NAACP Legal Defense and Educational Fund
National 4-H Council
National Academy of Public Administration
National Action Council for Minorities in Engineering (NACME)
National Alliance for the Mentally Ill
National Alliance of Business
National Artists Equity Association
National Assembly of Local Arts Agencies
National Assembly of National Voluntary Health and Social Welfare Organizations
National Assembly of State Arts Agencies (NASAA)
National Assistance League
National Association for the Advancement of Colored People
National Association for Visually Handicapped
National Association of Community Action Agencies
National Association of Homes and Services for Children

National Association of Independent Colleges and Universities
National Association of Independent Schools
National Association of Schools of Art and Design
National Association of Schools of Dance
National Association of Schools of Music
National Association of Schools of Public Affairs and Administration
National Association of Schools of Theatre
National Association of Service & Conservation Corps.
National Association of Student Personnel Administrators
National Association of United Methodist Foundations
National Associations in Colorado Springs
National Audubon Society
National Board for Professional Teaching Standards
National Catholic Development Conference
National Catholic Educational Association
National Center for Learning Disabilities
National Center for Nonprofit Boards
National Charities Information Bureau
The National Children's Advocacy Center
National Civic League
National Committee for Citizens in Education
National Committee for Prevention of Child Abuse
National Committee for Responsive Philanthropy
National Community AIDS Partnership
National Concilio of America
National Congress for Community Economic Development
National Congress of Parents and Teachers
National Consumers League
National Council for Adoption
National Council for International Visitors
National Council for Research on Women
National Council of Educational Opportunity Associations
National Council of Jewish Women
National Council of La Raza
National Council of Non-Profit Associations
National Council of Private Agencies for the Blind
National Council of the Churches of Christ in the USA
National Down Syndrome Society
National Easter Seal Society
National Education Association
National Environmental Education and Training Foundation
National Executive Service Corps
National FFA Foundation
National Fish and Wildlife Foundation
National Foundation for Cancer Research
National Fund for Medical Education
National Geographic Society Education Foundation
National Headache Foundation
National Health Council
National Health Foundation
National Hispanic Scholarship Fund
National Home Library Foundation
National Hospice Organization
National Humanities Alliance
National Institute Against Prejudice and Violence
National Institute for Dispute Resolution
National Institute for the Conservation of Cultural Property
National Leadership Coalition on AIDS
National Lekotek Center
National Low Income Housing Coalition
National Medical Enterprises
National Medical Fellowships
National Military Family Association
National Multiple Sclerosis Society
National Neighborhood Coalition
National Network of Runaway and Youth Services
National Park Foundation
National Press Foundation
National Psoriasis Foundation
National Public Radio
National Puerto Rican Coalition
National Retiree Volunteer Center
National Society for Experiential Education (NSEE)
National Society of Fund Raising Executives

National Stroke Association
National Trust for Historic Preservation
National Urban Fellows
National Urban League
National Victim Center
National Wildlife Federation
National Youth Employment Coalition
National/United Service Agencies (N/USA)
Native American Rights Fund
Natural Resources Defense Council
The Nature Conservancy
Neighborhood Housing Services of America
New Hampshire Charitable Fund
New Haven Foundation
The New York Community Trust
New York Life Foundation
The New York Public Library
New York Regional Association of Grantmakers
New York Times Company Foundation
Nokomis Foundation
Nonprofit Coordinating Committee of New York
Nonprofit Management Association
The Nord Family Foundation
Nordson Corporation Foundation
Norfolk Foundation
North American Association for Environmental Education
North Carolina Center for Nonprofit Organizations
Northern California Grantmakers
Northwest Area Foundation
NOW Legal Defense and Education Fund
NYNEX Foundation
Oakleaf Foundation
OICs of America
OPERA America
Operation Smile International
Outward Bound
Pacific Telesis Foundation
David and Lucile Packard Foundation
Community Foundation for Palm Beach & Martin Counties
Parent Action
Park Ridge Center for the Study of Health, Faith and Ethics
Partners of the Americas
Pax World Service
Peninsula Community Foundation
J.C. Penney Company
People-to-People Health Foundation
Pew Charitable Trusts
The Pfizer Foundation
Phelps-Stokes Fund
Philip Morris Companies
Piton Foundation
The Pittsburgh Foundation
The Planetary Society
Planned Parenthood Federation of America
Points of Light Foundation
Population Council
Population Resource Center
Population-Environment Balance
Premier Industrial Foundation
Presbyterian Health Foundation
Presbyterian Health, Education and Welfare Association
Presbyterian Women
Presidential Classroom for Young Americans
Prince Charitable Trusts
Princeton Project 55
Private Sector Initiatives Foundation
Procter & Gamble Fund
Project SEED
Prudential Foundation
Public Affairs Council
Public Agenda Foundation
Public Education Fund Network
Public Leadership Education Network
Puerto Rican Legal Defense and Education Fund

Quest International
Radio and Television News Directors Foundation
Rainbow Research
Rainforest Action Network
Ray Foundation
Raychem Corporation
Raytheon Company
Reader's Digest Foundation
Reading is Fundamental
Recording for the Blind
Refugees International
Reinberger Foundation
Religion in American Life
Renewable Natural Resources Foundation
Research! America
Retirement Research Foundation
Charles H. Revson Foundation
Rhode Island Foundation
Sid W. Richardson Foundation
RJR Nabisco Foundation
Rochester Area Foundation
Rockefeller Brothers Fund
Rockefeller Family Fund
Rockefeller Financial Services
Rockefeller Foundation
Rohm and Haas Company
Rosenberg Foundation
SAFECO Insurance Companies
The Saint Paul Companies
Saint Paul Foundation
The Salk Institute for Biological Studies
Salvation Army
San Francisco Foundation
University of San Francisco-Institute for Nonprofit Organization Management
Save the Children Federation
Dr. Scholl Foundation
The School For Field Studies
Scientists' Institute for Public Information
Seafirst Bank
Sears, Roebuck and Co. Sears/Coldwell Banker/Dean Witter/Allstate
Seattle Foundation
Second Harvest
Shell Oil Company Foundation
Shepherd's Centers of America
Sherwin-Williams Company
Shubert Foundation
Siegfried Foundation
Sierra Club
Sierra Health Foundation
Harry Singer Foundation
The Skillbuilders Fund
Skillman Foundation
Alfred P. Sloan Foundation
The Christopher D. Smithers Foundation
John Ben Snow Foundation
Community Foundation for Southeastern Michigan
Southern California Association for Philanthropy
Southern Education Foundation
The Spencer Foundation
Spunk Fund
State Legislative Leaders Foundation
W. Clement & Jessie V. Stone Foundation
Aaron Straus and Lillie Straus Foundation
Levi Strauss Foundation
Student Conservation Association
The Studio Museum in Harlem
Subaru of America Foundation
Support Centers of America
Synergos Institute
Taconic Foundation
Taft Institute
Tandy Corporation
Anne Burnett & Charles Tandy Foundation
Community Foundation of Metropolitan Tarrant County

03/29/93 *INDEPENDENT SECTOR VOTING MEMBERS*

The Taubman Company
TCF Foundation
TechnoServe
Tenneco
Texaco Foundation
Theatre Communications Group
3M
Time Warner
Travelers Aid International
Trident Community Foundation
The Trilateral Commission
The Parish of Trinity Church in the City of New York
Trust for Public Land
TRW Foundation
U.S. Trust Company of New York Foundation
Union Institute Center for Public Policy
United Cerebral Palsy Associations
United Leukodystrophy Foundation
United Negro College Fund
United States Catholic Conference
United States Space Foundation
United States-China Educational Institute
United Way of America
US West Foundation
USX Foundation
Vellore Christian Medical College Board (USA)
Vesper Society
Visiting Nurse Associations of America
Volunteers of America
Volvo North America Corporation
Izaak Walton League of America
Warner-Lambert Company
Washington Center
Washington Council of Agencies
Washington Mutual Savings Bank
WAVE
The Wege Foundation
Weingart Foundation
Weyerhaeuser Family Foundation
Mrs. Giles Whiting Foundation
Amherst H. Wilder Foundation
Woodrow Wilson National Fellowship Foundation
The Winston-Salem Foundation
Wisconsin Energy Corporation Foundation
Women and Foundations/Corporate Philanthropy
Women in Communications
Women's Action Alliance
Women's Research & Education Institute
Women's Technical Assistance Project
Robert W. Woodruff Foundation
Woods Charitable Fund
Greater Worcester Community Foundation
World Federation for Mental Health
World Resources Institute
World Vision
World Wildlife Fund
Wyman Youth Trust
Xerox Corporation
YMCA of the USA
Young Audiences
Youth Service America
YWCA of the USA
Zellerbach Family Fund

INDIANAPOLIS MOTOR SPEEDWAY CORPORATION
MAINTAINING THE GREATEST RACE COURSE IN THE WORLD

ANTON H. GEORGE
PRESIDENT

March 12, 1993

TO: The Honorable Andrew Jacobs
Attn: Mr. David Wilds
United States House of Representatives
2313 Rayburn Building
Washington D.C. 20515

RE: Deduction Rate of Entertainment Expenses

I would like to make you aware of my concerns regarding the proposed reduction from 80 percent to 50 percent on the federal tax deduction of entertainment/hospitality expenses allowable to corporations. Both my mother, IMS Chairman Mari George, and I feel this would be a threatening development not so much to the Speedway Corporation but to all the businesses and people who depend on the "500" for varying degrees of their livelihood.

Briefly stated, these concerns are:

• **Reduction in the "500's" economic impact for central Indiana**

Herein lies the collateral and tangible benefit the Indianapolis 500 has on the economy of central Indiana. We have seen estimates that put the overall local economic impact figure for the "500" in the range of $100 million annually. Business hospitality plays an enormous role in this equation, making Indianapolis a healthy environment for service industries.

• **Jobs will be lost in central Indiana**

Given the considerable number of business guests who use area hotels, restaurants and other "people" oriented services during May in direct conjunction with the "500," lowering the tax deduction for entertainment expenses will inhibit the propensity of companies to spend dollars in central Indiana, and thereby diminish the profit and employment potential of virtually every one of these businesses in the area. In short, adopting this proposal, I am convinced, will reveal its cost in, and be tied directly to, the loss of jobs in Indiana.

4790 WEST 16TH STREET • INDIANAPOLIS, INDIANA 46222
TELEPHONE 317/247-6500

MAILING ADDRESS. P. O. BOX 24152 • SPEEDWAY, INDIANA 46224
FAX 317/248-6759

• Jobs will be lost at the Speedway

Demand will subside for our internal hospitality services, which include catering, maintenance and security for 91 executive suites and approximately 100 other rental facilities on site. The result will be fewer Speedway employees for the month of May.

• Hospitality consumption tax revenue will decrease

Surtaxes are already collected on hotel (5 percent) and food and beverage (1 percent) expenditures in Marion County. Fewer expenditures will reduce this direct tax revenue.

• Decrease in the area's exposure for economic development purposes

Thousands and thousands of people are in Indianapolis as business hospitality guests throughout race month. Business guests tend to be decision makers, executives, people who have won performance-related company incentive contests. These people, these highly productive people, are exposed to Indianapolis. They see our TV newscasts and our local advertising. They meet and interact with local people and businesses. They visit museums and learn of our good, central Indiana quality of life. Indianapolis is provided a built-in national and international forum from guests in town for the race. This is a powerful economic development tool. The value of these contacts, while admittedly intangible, is also incalculable.

• Businesses in central Indiana and elsewhere, will be less able to use the "500" as a beneficial marketing tool

Hundreds of central Indiana companies utilize business entertainment opportunities at the "500" as a creative and effecting marketing tool. It is our experience that these area businesses find this mix of racing and business both profitable and enjoyable. Of course, this is a concept which translates to all forms and locales of businesses and all types and venues of hospitality.

• IMS will reduce its own corporate entertainment expenses

We would re-evaluate the money we spend as a company on entertainment. First on that list is the suite we have leased at the Hoosier Dome for entertainment purposes the past eight years. Businesses are urged to support the Dome as a civic facility, but this kind of high-dollar expentiture will be more difficult to justify without the recompense of tax deductions.

Thank you for considering these thoughts. Reducing the entertainment expense deduction rate will have adverse affect in many sectors of the economy, and I wanted you to be aware of our position in this matter.

Respectfully,

Tony George

Tony George
President
Indianapolis Motor Speedway Corporation

TO: The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

FROM: Carl V.J. Norman
President/CEO
INOFETZ PHASE ONE, INC.

DATE: March 23, 1993

RE: President Clinton's Proposals for Public Investment and Deficit Reduction

Honorable Mr. Rostenkowski and Members of the Committee on Ways and Means:

As President and CEO of INOFETZ, Inc., I am honored to make this presentation before this committee regarding the above-captioned matter. I am confident that the "committee" receives many replies from interested parties who make a diversity of comments about deficit reduction. However, I am confident that the staff members of INOFETZ, Inc. have the answer and solution to reduce the deficit by significant proportions without raising taxes.[1] INOFETZ's interest in the deficit reduction plan originated in the second term of the Reagan Administration.

My group met with Samuel Pierce in 1986 to introduce a program called **HOPE-INOFETZ** that was designed to create 12 million new jobs throughout America without any loss of monies to the United States government. The HOPE INOFETZ Project is designed to remove 5.4 million people from welfare; to remove 75 percent of America's homeless from the street; to provide low-cost housing ownership for inner-city residents; to provide new businesses while activating plans to re-open industrial and manufacturing facilities and marketplaces that create a diversity of jobs for Americans of "all" income levels.

The HOPE-INOFETZ proposal was lost in the corruption that plagued the U.S. Department of Housing and Urban Development. Through the World Conference of Mayors (WCM), the matter was pursued with no success. The HOPE-INOFETZ plan was then introduced to the National Conference of Black Mayors under Secretary Ronald Leverett who was the Mayor of Prairie View, Texas at that time. Mr. Leverett met with then Vice President Bush on economic growth which works to reduce the deficit. HOPE-INOFETZ represents one vast project that reaches disadvantaged people in the have-not communities of the United States and creates opportunities for them to become productive Americans. Through corruption in HUD and other negative contributing factors, HOPE-INOFETZ was separated and broken down into two projects:

[1]Without raising taxes in this program presented by INOFETZ.

(A) HOPE--Home Ownership Opportunity for People Everywhere;[2] (B) INOFETZ--International Network of Free Enterprise Trade Zones.[3] Politicians and the American people remember the concept under a different title--Enterprise Zones. The concept failed after alteration by HUD officials. Congress never approved monies for HOPE or Enterprise Zones. I applaud Congress for not funding the HOPE-Enterprise Zones Project because the original project rejected any and all federal grants because it was part of an overall formula to reduce the federal deficit.

During the Reagan-Bush era, I had the opportunity to research 300 cities throughout the United States for the implementation of HOPE-INOFETZ. During the Bush era, Governor Clinton chaired the Committee on the Lower Mississippi Delta Initiative, research that cost the government $10 million. My staff benefitted from that research and perfected an economic development plan for the Lower Mississippi Delta during the Bush Administration's final year in office. HOPE INOFETZ was "perfected" into a "job-producing, deficit-reduction project."

It is important for the Committee and members of Congress and the Senate to understand that the HOPE-INOFETZ Plan took more than five years to "perfect" and the entire plan cannot be presented in this one presentation. This presentation is to give each member of the Committee a synoptical overview of HOPE-INOFETZ and the significant ramifications it could have on President Clinton's overall economic development plan to overhaul the American economy. In support of that, I now present the following:

Problems, Answers and Solutions

Problems

The federal deficit was created by a variety of deficiencies that created what is called income blockage, meaning that the federal government was pouring monies into buckets that had no bottoms. This meant that government spending was "out of control" with no significant income to balance the spending and expenditures of the federal dollars, thus creating what we now face as the federal deficit, a debt that exceeds $1.4 trillion ... and still counting.

Most Americans recognize that there is a problem, but what most Americans fail to understand is what is the problem. The problem is rooted deep in corruption. The federal deficit expands beyond the mathematical interpretation of "dollars and cents," the balancing of budgets and the creation of jobs and training programs. As you are aware, this type of thinking has been in existence since 1949 and government spending has created a monster that must be destroyed. This monster is better recognized as political cliques. Consequently, this monster was created through political bartering that utilized federal dollars to control certain political territories through the creation of bogus, illegitimate, non-profit organizations that "bilk" the government out of billions of dollars each year without returning one dime back to the government. Many of these organizations fail to roll-over federal investments which creates a serious problem. When an organization is created to provide a community service, receives federal monies to do so and fails to provide those services ... These organizations are best recognized as your local housing authorities, corruption is rooted in this agency. Thousands of housing units are being subsidized by the

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[2] This caption and title remains in its original form.

[3] This name INOFETZ was changed to Enterprise-Zones.

federal government that are "not being occupied" by tenants. There are an estimated 100,000 housing units throughout the United States that fall within this category. A simple mathematical breakdown average per unit of $300, the government cost per unit is approximately $350 per unit with all costs included, i.e., maintenance and administrative costs. Up until 1991 HUD paid for unoccupied units as if someone were living in them. When HUD failed to enforce federal laws many of the housing authorities failed to provide affordable and decent housing to needy people by allowing these units to go unoccupied. For as long as ten years, while they were still receiving monies from the federal government for (1) the housing unit, (2) the maintenance cost of each unit, (3) the administrative cost to oversee the housing complex; when these costs are brought under scrutiny by simple math it is a disaster to the federal deficit.

1. $350 x 100,000 unoccupied units = $35,000,000 per month x 12 months = $420,000,000 per year.

2. $420,000,000 x 10 years = $4,200,000,000 lost by the federal government.

3. The government loses $315 million in rental income per year for a total of $3.15 billion over the ten-year period.

There are thousands of non-profit organizations that are under contract with these housing authorities to build low-income housing units for $30,000 per unit with cost over-runs of $40,000-50,000 per unit. Now a $30,000 unit costs $70,000 to $80,000 to build with HUD financing 80 percent of the construction costs and construction cost over-runs. According to HUD's own records, approximately $2 trillion has been spent on socio-economic development programs since 1949, yet the areas where this money was allegedly spent remain ghettoes with limited job creation, worthless job training programs and insignificant retraining programs.

Then there are the redevelopment authorities which receive millions of dollars in federal grants for administrative costs to issue $2,000 red tape grants to friends and relatives. These RDA agencies operate from fed-funds to provide basic community services that they fail to provide at a cost to the federal government of hundreds of millions of dollars per year. Yet there are still ghettoes in the affected areas.

The third problem that is the ultimate problem of them all falls within the banking industry in which I have been involved in extensive investigations concerning corrupt banking practices that monopolize and manipulate federal dollars and violate the Community Reinvestment Act of 1977. This corruption throughout the banking industry has caused "economic disaster in poor communities nationwide." Although devastating to the inner-cities, it causes shotgun injuries to the federal deficit. This corrupt conduct has destroyed inner city communities throughout the United States because their lack of investments in poor communities has caused approximately 7 million inner-city residents to be out of work. This burdens the government and causes deficits on all three levels--city/municipal government, state government and the federal government--which borrow more money than they can pay back. When the above two problems are added to this banking problem, it makes the economy a federal dependent. When this is combined with the jobs lost in other areas such as those due to plant layoffs, the federal deficit would increase because in spite of higher taxes and balancing the federal budget, the fed-system would continue to shell out more than they would bring in, thus being forced into seeking new ways for deficit reduction where there is no answer under the current system.

The Clinton Administration is faced with yet another problem in the health care industry, followed by the elimination of jobs through the closing of military bases. By basic deduction, we compare approaches to solving the problem. For example:

Health care reform is "not a realistic" approach to making "quality health care" available to all needy Americans. In order to reform something it has to be willing to submit to reform. The health care industry in America does not wish to be reformed. CBS News recently identified a lady who was charged $300 by a hospital for five sticks of nicotine gum ($60 a stick). So when we think of health care reform, no one can place a value on a system that is totally out of control; it is infested with faulty billing systems, corruption, waste and fraud. There is nothing that reformation can grasp onto and so what is there to reform?

Monies (billions of dollars) are being promised to federal employees who are about to lose their jobs, while health care reform is estimated in the billions of dollars. Assuming that both challenges were met, where would the money come from to satisfy this phase of the recovery plan? Raising taxes in America to raise income is an unstable proposition because of the many "tax loopholes" that exist within the current system. Nevertheless, assume that taxes were raised to fund the proposed economic plan. Then the President's economic recovery plan would immediately "consume" this newly found income. From the proposal, it is estimated that $90 to $120 billion would be spent on health care, job retraining and job stimulation programs which would be mathematically unstable. Health care, job retraining and stimulation of the economy represent three different aspects of the same problem which is "costly" for the government. What HOPE-INOFETZ would do is establish order by focusing on the same issues under one umbrella from the private sector. HOPE-INOFETZ's approach is well organized and guarantees that the outcome will be successfully completed without the waste of federal monies and energy, and at the same time benefit America on issues that the American people so eagerly anticipate.

Answer

I neither agree nor disagree with the President's economic recovery plan or the First Lady's proposed plan for health care reform. However, I will comment that both plans are achievable and well within reach. Briefly, I would like to take this opportunity to expound on what answers were revealed through HOPE-INOFETZ's research on the exact same issues.

The answers are not found in budgets and adequate capitalization; there is a two-step process to solving the mystery of balancing the federal budget, reducing or eliminating the federal deficit and creating new jobs, without compromising President Clinton's Economic Recovery Plan and without criticizing the proposed health care reform plan of the First Lady, but more importantly in satisfying the requirements of the Congress, the Senate and the American people.

The First Step to Economic Recovery and Health Care Reform

The first step toward economic recovery and health care reform is to develop two basic oversight agencies. The first agency would be set up for the purpose of establishing enforcement policies of federal programs.

Special Prosecutor and Its Function

We seek the establishment of a Special Prosecutor, separate and independent of the United States Attorney General. This Special Prosecutor should be appointed by the President and members of congress for the following purposes:

1. To investigate fraudulent and false Community Reinvestment Act Performance Evaluation Reports that are submitted to the various regulatory agencies.

The significance of this investigation is to uncover a conspiracy in the banking industry which costs the federal government billions of dollars each year in various forms of revenue because of gross violations of the Community Reinvestment Act. These violations are so serious they extend beyond the depths of organized crime. In dollars and cents, it extends beyond hundreds of billions of dollars nationwide in lost revenue for the federal government through various federal crimes such as violation of the Organized Crime Control Act of 1970 and violation of the Sherman Anti-Trust Act. Congress must step forward and hold their own investigations because the Board of Governors of the Federal Reserve System is part of the problem of this corruption. They are covering up violations of federal banking laws and crimes against poor people in the inner cities.

Note: This statement is not just a cry of racism, but an exposure of corruption and economic oppression condoned by the regulatory agencies. Therefore, only congress and the President of the United States may demand that their records be made available. Over the past 20 years, you will uncover the biggest bank scandals in the United States, the same pattern of misconduct that led to the fall of many S&L's in the recent past.

2. The housing authorities throughout the United States are scamming the U.S. Government out of monies every year by not providing affordable and decent housing as they are paid for by the federal government.

Note: We have thousands of pages on this subject matter to prove that this statement is true with witnesses from the grass roots communities.

If Congress continues to allow this illegal activity to go unchallenged, the government will continue to invest in projects where there is no return on the investment wherein technically the government is contributing to and prolonging the life of "white collar organized crime" in the housing authorities. Again, we are looking beyond racism and focusing on "economic oppression."

3. Local politicians and agencies utilize federal dollars to finance their political careers through a bartering system. Federal dollars are allocated to corrupt community-based organizations which apply for federal monies at one amount and have cost over-runs in their projects of three to four times the amount originally requested.

The need for a Special Prosecutor and a congressional investigation is long overdue. This would be the answer to plugging up the holes to allow these monies to reach their intended destination and to force banks to comply with federal laws. The first step to achieving this goal is to have a "shake-up" in your regulatory agencies by sending a strong message by "firing Alan Greenspan." He is a liar who constantly feeds congress false information about the economy. Greenspan must go; there must be a serious shake-up in the banking industry, with the enforcement of the Community Reinvestment Act of 1977, the

Organized Crime Control Act of 1970 and the various anti-trust laws. If these crimes are allowed to continue every American will suffer because of the crimes of a few and the deficit would never be reduced because of the billions of federal dollars that are being lost through this criminal activity.

Reducing the deficit creating jobs and developing health care is the responsibility of all Americans, not just the Clinton Administration. Our cries must be noted and we must be committed to bringing about change in America for "all Americans."

Solution

The Clinton Administration has listened to the cries of the American people for "change"; now that the Administration is aware that "the problem" is greater than what was first expected, they, too, cry out for "help" and answers while seeking solutions to the problems that plague America.

The **solution** is HOPE-INOFETZ which is a complete economic recovery system that is designed to "overhaul the economy and produce a new health care system" while generating enough capital to **reduce the federal deficit in eight years.**

Financial Breakdown on Solution

Deficit Reduction Budget	$1,307,359,622,400
Budget Reduction Program	1,080,000,000,000
New Health Care System Budget	974,263,680,000
Implementation of 12 Million New Jobs[4]	405,943,200,000
Nationwide Housing Project[5]	556,025,000,000
Community Development[6]	95,840,000,000
Health Care Facilities Phase One	103,184,999,890
TOTAL COST - 7 CATEGORIES	$4,619,456,502,290

HOPE-INOFETZ is a system that stands for Home Ownership Opportunity for People Everywhere--International Network of Free Enterprise Trade Zones.

This system encompasses the very aspects of economic recovery that the Clinton Administration is trying to accomplish. The vastness of HOPE-INOFETZ effectively produces private sector enhancers that contribute to the Clinton proposals for:

Deficit Reduction Budget	$1,307,359,622,400
Budget Reduction Program	1,080,000,000,000
New Health Care System Budget	974,263,680,000
Implementation of 12 Million New Jobs	405,943,200,000

[4]These 12 million jobs would be implemented in less than two years, averaging 400,000 every month.

[5]The housing project would be completed within five years and implemented immediately.

[6]Community development project implemented immediately.

Nationwide Housing Project	556,025,000,000
Community Development	95,840,000,000
Health Care Facilities Phase One	103,184,999,890

It will take much vision to comprehend HOPE-INOFETZ's long-term economic recovery plan for 300 cities throughout the United States (covering 90 metropolitan cities, 210 small cities with populations of 50,000 or less, the Lower Mississippi Delta encompassing 231 counties). The total plan will affect 25 million Americans, inclusive of the implementation of 12+ million new jobs. Total health care included for each position, plus health care for an additional 13+ million for individuals who have no health care or partial health care coverage. The totality of the project will be implemented under a $4.6 trillion budget broken down as follows:

Direct contribution from HOPE-INOFETZ to the United States Government: $2,387,359,622,400

Direct contribution from HOPE-INOFETZ to the new Health Care System: $ 974,263,680,000

Direct contribution from HOPE-INOFETZ to the new jobs program: $ 405,943,200,000

Direct contribution from HOPE-INOFETZ to community housing: $ 556,025,000,000

Direct contribution from HOPE-INOFETZ to community development programs: $ 95,840,000,000

Direct contribution from HOPE-INOFETZ to Phase One Health Care Facilities: $ 103,184,999,890

Direct hands-on involvement in the overall project by INOFETZ Phase One to oversee the administration of the $4.6 trillion project.

Implementation of the HOPE-INOFETZ Plan

The implementation of the HOPE-INOFETZ plan is a four-step process that would be implemented simultaneously in 300 cities and broken down as follows:

A. An official federal mandate from the Office of the President of the United States and from the U.S. Congress.

B. An immediate $5 million discretionary loan guarantee from the Office of the President of the United States as soon as possible.

C. HOPE-INOFETZ seeks a discretionary loan guarantee in the amount of $3.5 billion for the purpose of implementing the enclosed project of $4.6 trillion.

Note: The $3.5 billion would be released to loan guarantees. More importantly, these loan guarantees would be matched with "cash" dollars and credit lines in the same amounts which becomes $7 billion in start-up capital. This $7 billion is matured into a $4.6 trillion project that returns $2.3 trillion back to the federal government.

D. HOPE-INOFETZ will implement an economic summit for the purpose of releasing confidential information to the public. The summit will be held immediately and will run for seven (7) days. The theme of this economic summit will highlight the HOPE-INOFETZ Project to the U.S. Governors, the U.S. Conference of Mayors, the National Conference of Black Mayors and the general public through 1-900 and 1-800 numbers.

The overall plan is supported by hundreds of pages of footnoted data and charts that substantiate the enclosed presentation. Through the Economic Summit, it is HOPE-INOFETZ's intention to expose the totality of the HOPE-INOFETZ Plan to the public.

The implementation of this project consists of two steps, the first of which is $5 million for the initial start-up to coordinate and raise the matching funds of $3.5 billion. We seek the amount of $5 million immediately and within 90 days the sum of $3.5 billion in loan guarantees from the United States Government. These monies can be released to HOPE-INOFETZ through President Clinton's "Discretionary Fund." In essence, INOFETZ Phase One, Inc.'s official request is in the form of two loans: (1) $5 million in federal loan guarantees in the form of marketable securities, and (2) a second loan for $3.5 billion in the form of marketable securities. Both loans would be no-interest loans for a period of three years.

Step two would be implemented upon committing to the two loan guarantees. INOFETZ, Phase One, Inc. would then implement Project HOPE-INOFETZ which would create 400,000 new jobs per month or 4,800,000 in the first year. In the 13th month, the project would then produce 600,000 new jobs per month for the next 12 months, yielding 7,200,000 new jobs in the second year for a total of 12 million new jobs. HOPE-INOFETZ would employ approximately 100,000 people in-house to carry out all phases of the HOPE-INOFETZ project.

And so the U.S. Government's investment in INOFETZ Phase One, Inc. would be in two steps: (1) $5 million; (2) $3.5 billion for this project to produce the above results. Technically, this production does not cost the government anything because all the investments would be repaid in 36 months. Such an investment by the Clinton Administration would be prudent and wise.

I appreciate the opportunity that the committee has extended and sincerely hope that this information will be used to benefit mankind in America.

God bless each of you.

Respectfully submitted,

Carl V.J. Norman
President/CEO
HOPE-INOFETZ

CVJN/fe250

cc: National News Release
U.S. Governors
U.S. Conference of Mayors
National Conference of Black Mayors
Staff

PROPOSED OPERATING STAFF OF INOFETZ PHASE ONE, INC.

These are the individuals who will assist in implementing the HOPE-INOFETZ programs:

STAFF

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President/CEO
Chairman of the Board

Ron Leverett
Senior Vice President
Corporate Affairs

Charles R.K. Powell
Executive Vice President
International Trade

P.W. Frazier
Vice President
Treasurer

Marian G. Powell
Vice President
Reinsurance

Erleen Leverett, Ph.D.
Vice President
Education

Glenda Island, Ph.D.
Vice President
Marketing-Economics

Dennis Judd, Ph.D.
Vice President
Super Collider

Asia Cooney
Vice President
Community Development

Joyce Hall, Ph.D.
Vice President
Community Development
U.S.A.

William Moyer, P.E.
Vice President
Energy

Dorothy Carn, P.E.
Vice President
Engineering

Thomas M. Barrian, P.E.
Vice President
Cost Estimating Engineer

Samuel E. Olshin
Architect
Project ACDC - MC-DC

Edward Parrine, P.E.
Vice President
Electrical Engineer

David Howell, Ph.D.
Vice President
Telecommunications

James Wang, Ph.D.
Vice President
INOFETZ International H.K.

Gary Lee Jones
Vice President
Manufacturing

Titus C. Hall
Vice President
Computer Systems

Earl Lucus
Vice President
INOFETZ Lower Miss. Delta

O. D. Frazier
Vice President
Small Business/Vendor Coord.

John Macklin
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First Vice President, B.M.
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Executive Vice President
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SWEBCO Swedish Trade Council USA

Joseph Schroer, Jr.
Manager
NFIB

Hans Viessmann
President, CEO
VMC, Inc. - Germany

Hank Schoefell
Vice President
Pru-Bache Securities

John H. Simon
President/CEO
UMEA, Inc.

TESTIMONY OF
THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
(INGAA)
TO THE HOUSE WAYS AND MEANS COMMITTEE
ON THE PRESIDENT'S DEFICIT REDUCTION PROPOSAL

MARCH 23, 1993

Mr. Chairman and Members of the Committee I appreciate having the opportunity to submit testimony for the record of the Ways and Means Committee on the President's deficit reduction proposals. My name is John Riordan and I am the President and Chief Executive Officer of MidCon Corp. headquartered in Lombard, Illinois. I am also the Chairman of the Interstate Natural Gas Association of America (INGAA) on whose behalf I am testifying. INGAA represents the U.S. interstate and Canadian interprovincial natural gas pipelines.

I would like to address today the issue of the Btu tax, specifically the collection point for natural gas, discuss the financial impact on pipelines of changes in the gas industry and raise other technical concerns we have with some of the provisions raised in President Clinton's proposed package.

The Natural Gas Btu Tax Should be Imposed on the Ultimate Consumer and Collected by the Seller of the Gas

When the Administration released its proposal, it recommended that the collection point be placed at the front or upstream end of the natural gas pipeline. The intent of the energy tax is to generate revenues from the users of the energy, with certain feedstock exemptions. This means the tax should be borne by the end-users or consumers of the energy. *Thus, a tax on natural gas should be imposed on the end-user and collected by the seller of the gas.* This is a position supported by the Natural Gas Council, a group comprised of the American Gas Association, the Interstate Natural Gas Association of America, the Independent Petroleum Association of America and the Natural Gas Supply Association.

Pipeline Collection

We have heard that the Clinton Administration is considering imposing the tax upon Btu's measured at the outlet of the pipeline. This could mean the interstate pipeline is the collector of the tax from the end-user or local distribution company (LDC). While this is *not* the mechanism supported by the Natural Gas Council, if it is the ultimate approved mechanism, clarification should be added so that the intent of the energy or Btu tax remains intact.

- Interstate pipelines should be required to remit to Treasury only what they collect from end-users or LDCs.

- LDCs must be guaranteed regulatory approval to recover the tax

(this will require a federal pre-emptive clause ordering public utility commissions to allow LDCs to pass on the tax.)

- To avoid any double taxation (tax on tax), legislative language must be included stating that any Btu tax collected would not be subject to any other form of federal, state or local taxation.

Collecting Tax at the Pipeline Point-of-Entry Would be Unmanageable

INGAA believes that convincing arguments have been and continue to be made for why the collection point should not be at the wellhead, the front or upstream end of the pipeline, the back or the downstream of the pipeline or the city gate. The following comments focus on the Btu tax as described in the Administration's proposal which named the entry to the pipeline as the gas collection point. Taxing natural gas at the pipeline point-of-entry would require a massive tracking system that would be both unmanageable and could be inaccurate. In 1992, under "open access" regulations, 84% of the gas going through pipeline systems was owned by others and merely transported by the pipelines. Only 16% of the gas was sales gas, i.e., owned by the pipeline. As a result of recent federally mandated restructuring of the natural gas industry, interstate pipelines will no longer buy and sell virtually any of the gas that goes through their pipelines. They will simply serve as transporters of gas owned by others. Title to the natural gas commodity will not be conveyed at any time to the pipeline. Pipelines also will have no knowledge of the actual end-use consumer nor the non-fuel use status for exemptions of entities ultimately consuming the gas.

Collecting the tax at the entry to the pipeline, as initially proposed by the Administration, is not manageable because of the complexity and confusion resulting from the restructuring. While gas transmission may seem simple, it is a complex network of transactions which, after restructuring, will be even more complex. Before the restructuring of the natural gas industry, a natural gas purchase typically consisted of a handful of individual transactions between the:

- producer and shipper (person who arranges the deal if the ultimate consumer does not do the arranging himself)
- shipper and the ultimate consumer
- shipper and the pipeline

After the restructuring, a natural gas purchase will typically consist of many more individual transactions *in addition to* the ones listed above; that is, between the

- shipper and storage owner (because purchase of storage capacity will be a separate service)
- shipper and other shippers (because gas will be pooled at market centers along the pipeline)
- pipeline and an upstream or downstream pipeline (because the restructuring releases market forces which are demanding this type of service)
- shipper and another customer (again, because of pooling at market centers)
- customer and other customers (because pipelines must allow

customers to release their rights to the pipeline capacity to another party)
- customer/shipper with other customers and shippers (because of the right of customers and shippers to substitute different receipt and delivery points along the pipeline).

Other combinations are likely and could happen over and over again. For instance, many expect the title to the gas to change hands repeatedly within a market center. As a result, the number of transactions for a single delivery could easily be dozens. It is difficult to develop a rationale for applying the tax before these many title changes are made.

Another problem is that an interstate pipeline transports natural gas to an exit point. It then bills the shipper for the transportation service later, i.e., billing occurs after-the-fact. The pipeline collects revenue only from the party paying the transportation rates. That party often is not the party that will eventually own or use the gas.

Interstate pipelines are also facing more competition which creates more pressure for pipelines to discount their transactions. It is not possible to specify in a pipeline's rate what is being discounted and what is not. Consequently, unresolvable disputes would occur between pipelines and customers regarding whether a tax was paid. This problem is acute at the entry point to the pipeline.

Almost one trillion cubic feet of gas goes into storage facilities and may not be consumed for as long as a year. Requiring the pipelines to collect the tax would result in significant timing problems. There is also gas that is needed for line pack to maintain the appropriate amount of pressure and gas flow in the pipeline and for cushion gas in a natural gas storage reservoir. This natural gas is never consumed. Paying the tax at an upstream point would tax gas that is not used as energy.

The natural gas industry has undergone significant changes in the last ten years. Interstate natural gas, all of which was subject to regulatory price control until 1978, is now decontrolled. The gas pipeline industry has been transformed from an industry which once owned all the natural gas it transported to one that will own none of the gas in its system. Each pipeline will also offer services which were originally "bundled," but now will be offered to transporters separately. The pipeline industry has also become very competitive. If the Btu tax is placed on the pipeline system and pipelines incur costs which they cannot pass on, this could result in lessening competition and adversely impacting the financial health of the industry.

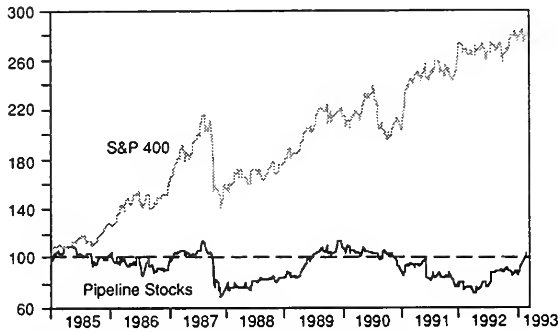
Financial Health of the Interstate Pipeline Sector

From the perspectives of both debt and equity holders, pipelines cannot incur any costs that cannot be flowed through to customers. First, the equity perspective.

The first significant indicator of performance is a company's stock. Over the long term, pipeline stock prices have suffered from the move to open

access. Pipeline stock prices have not grown as much as the S&P 400. The gap between these two representative indices is very wide.

Growth In Stock Prices
Pipeline Stocks vs. the S&P 400



Source: INGAA, using data from Standard & Poor's Compustate

The recent improvement in pipeline stock prices has returned the index of pipeline stock prices to just above where it was at the beginning of 1985 (to 103 on the comparative scale used).[1] In contrast, the standard index of industrial companies, the S&P 400, has climbed steadily; it now stands at 282 on the comparative scale used. These indices mean that a dollar's worth of stock invested in the pipelines in 1985 would still be worth a dollar today, while a dollar's worth of stock invested in the S&P 400 would be worth \$2.82, almost three times more than the pipelines.

Return on equity is the second major indicator of how well a company is performing from an equity perspective. Return on equity indicates how much of a return pipelines have been able to earn on the funds that its owners have invested as equity.

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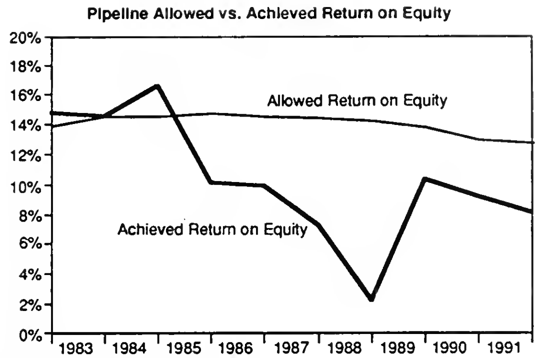
1 The pipeline index is a simple average of the stock prices of the publicly traded companies for which 40% or more of both the company's income and assets are attributable to the interstate natural gas pipeline sector. The companies included are: AlaTenn Resources, Arkla, Coastal, Columbia Gas System, Enron, KN Energy, Panhandle Eastern, Sonat, Transco Energy and The Williams Companies. El Paso is not included due to its short trading history.

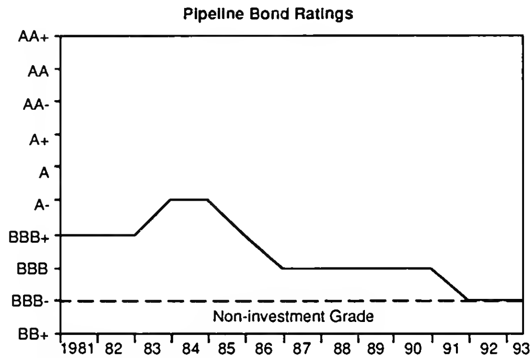


Source: Surveys of INGAA members

While allowed rates of return decided in rate cases before the FERC have gradually declined from nearly 15 percent in 1985 to just under 13 percent in 1991, actual earned rates of return have greatly underperformed the cutoff, falling from 10.1 percent in 1985 to 2.2 percent in 1988 and rising to only 8.1 percent in 1991.[2] Achieved return on equity has been well below that which has been allowed since the beginning of open access. While pipelines are not reaching the benchmark set by FERC, they are beginning to regain their financial health by this measure.

2 These actual rates of return are a weighted average of return on equity as reported by 23 individual pipelines to INGAA.

However, the prospects are troublesome as measured by bond ratings on the fixed-income side. After plummeting from their high of A- in 1984, bond ratings, which reflect future financial health, remain depressed.[3] At the end of February 1993, the average bond rating of the fifteen major interstate pipelines that are rated stood at "triple B minus" (BBB-), the lowest possible investment-grade rating.[4] One more reduction would mean that, on average, pipeline debt would be primarily speculative, similar to a junk bond.



Source: Standard & Poor's Bond Guide

These ratings are an indication of fixed-income analysts' lack of confidence in the likelihood of pipelines being able to meet future payments of interest and principal.

While recent returns to equity holders have improved, pipelines have a long way to go to obtain the return on equity allowed by the Federal Energy Regulatory Commission. Fixed-income analysts have yet to change their very negative opinions of pipeline's ability to repay debt holders. From both the equity and the debt perspective, the financial health of pipeline companies is too tenuous to warrant that pipelines be subject to any costs that cannot be passed on.

INGAA believes that the BTU tax should be applied at the point of final sale for consumption because doing so will maximize the amount collected and because there is no other point from the wellhead to the burner tip which is free of problems of ownership, end-use or timing.

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3 Bond ratings summarize how likely a company is to continue payments to its creditors. Fixed-income analysts give bond ratings from AAA to D based on the company's ability to repay interest and principal to the holders of its debt.

4 The average bond rating is the weighted average of the bond ratings of the following companies: ANR, Arkla, Colorado Interstate, Columbia Gas, El Paso, Northern Natural, Northwest, Panhandle Eastern, Questar, Southern Natural, Tennessee, Texas Eastern, Texas Gas, Transcontinental and Williams Natural Gas.

Additional Technical Considerations with the Deficit Reduction Proposal

BTU Tax

Placing a pipeline (or a distribution company) in the Btu taxing process will, in some instances, expose the pipeline to additional taxes generated from the receipt of the Btu tax amounts. To eliminate the possibility of any gross receipts tax exposure on these amounts, and to eliminate any possible first purchaser type problems associated with the pipelines involvement in this taxing process, as evidenced by the pipelines' historic problems in the Windfall Profits Tax and severance tax areas, we would urge that a provision be included in the legislative language adopting the Btu tax to the effect that any amounts collected not be subject to any other form of federal, state, or local taxation. Further, the entity remitting the tax to the Treasury should not be liable for any amount of the tax that is in excess of the amount collected from the party on whom the tax is imposed.

According to the *Summary of the President's Revenue Proposals* the collection point for imported taxable products is the importation point. If the importation point is upstream of the point at which the Btu tax is collected for domestic natural gas, this could lead to the double taxation of imported natural gas absent a layer of complexity. Canadian, Mexican and imported liquified natural gas can be taxed efficiently at the same point as domestic natural gas. Imported natural gas should be subject to a different taxing mechanism only if the place where it is imported is downstream of the point where the tax is collected from domestic sources.

Corporate Tax Rate Increase

The Administration proposes to increase the corporate tax rate from 34% to 36%, retroactive to January 1, 1993. Because taxes are a cost of service for regulated utilities, and cost of service adjustments must be approved by the applicable federal or state regulatory agency before such adjustments may be reflected in rates, it is of utmost importance that such a rate increase be prospective only. The effect of this "regulatory lag" is that utilities would in effect be forced to pay a higher tax without being reimbursed for the added expense in their rates.

Investment Tax Credit (ITC)

The investment tax credit as proposed is not fully effective due, in part, to the operation of the minimum tax. In order to derive the intended benefit, the ITC should be allowed to be utilized against the alternative minimum tax.

In line with previous ITC provisions, the incremental and permanent ITC proposals advanced by the Administration should be "normalized" to ensure that utilities are able to use the tax benefits for investment purposes.

The ITC should be allowed on all qualified purchases made in 1993 and 1994 as opposed to an incremental ITC. The President's proposal prevents companies that have reduced their spending because of the overall financial

situation to derive any benefits from the credits.

Alternative Minimum Tax Relief (AMT)

The *Summary of the President's Revenue Proposals* contains a provision to provide relief from the depreciation adjustments required by the AMT, but it may be more appropriate to grant AMT relief through the utilization of Minimum Tax Credits (MTC) against current year AMT. Capital intensive corporations have in essence prepaid their federal income taxes through the AMT but may not be able to utilize these credits in future years. We recommend that the AMT proposal be amended to enable a corporation to recover their MTC in a more timely manner.

Summary

In summary, a tax on natural gas should be imposed on the end-user and collected by the seller of the gas. This position is supported by the participants in the Natural Gas Council. If the tax is imposed at the outlet of the pipeline, that is, the pipeline is the collector of the tax from the LDC or end-user, then the following clarifications need to be made:

- Interstate pipelines only remit to Treasury what they collect from end-users or LDCs.

- LDCs must be guaranteed regulatory approval to recover the tax. This will require a federal pre-emptive clause ordering state commissions to permit LDCs to pass on the tax.

- To avoid any double taxation (tax on tax), legislative language must be included stating that any Btu tax collected would not be subject to any other form of federal, state or local taxation.

I also urge that you address the technical concerns I have raised in this testimony. Thank you.

AN EVALUATION OF THE CLINTON ECONOMIC PLAN AND ITS RELATIONSHIP TO PRIVATE ENTERPRISE, PERSONAL LIBERTY AND THE POWER OF THE FEDERAL GOVERNMENT

Presented By and **Representing an Individual Opinion Solely his Own Responsibility**:

Donald L. McEachron, Ph.D.
Research Associate Professor
Biomedical Engineering and Science Institute
Drexel University
Philadelphia, PA 19104

To the Members of the United States Congress and the General Public of the United States of America

Ladies and Gentlemen:

The purpose of this presentation is not to change or alter the opinions being presently expressed concerning the President's economic proposals nor do I expect that the arguments presented herein will materially effect the passage of those proposals by the Congress. The events of recent days have indicated to me that the President's Plan has gathered sufficient momentum to insure its implementation despite any negative consequences that I may outline within this document. Indeed, there are many who will not feel that these consequences are negative. Why, then, am I making this presentation?

I have two explicit reasons for making this document as widely available as possible. First, I am, by profession, a research scientist. As such, I am in the habit of developing hypotheses, deducing their implications, and testing these implications with further observations. The arguments presented can be thought of as hypotheses concerning the role of governments in controlling the economic affairs of their peoples. I would like to test these hypotheses to evaluate their predictive validity. To do so, I must make them publicly available before any consequences can have developed. Second, both the President and the Congress have shown a remarkable ability to avoid taking any responsibility for their statements or actions. For example, I have been constantly amused by the Democratic Party's efforts to blame the present economic situation on the past 12 years of Republican occupancy of the Executive Branch. While the Republican Party must shoulder its own portion of blame, I cannot help but wonder what the Democrats, who were in control of the House of Representatives for all 12 years and the Senate for 10 of the 12 years, were doing during this time. Perhaps the deficit could be trimmed somewhat by having the monies which were paid to Democratic congressmen and congresswomen returned. I cannot see why taxpayers should be paying for inactivity and the Democrats in Congress can only be blameless if they were taking absolutely no part in the budgetary process. Since a role for Congress is specifically described in the Constitution, the only way for the Democrats in Congress to remain blameless is for them to have failed to execute their duties and, in my opinion, people should not be rewarded for failing to do their duty. Thus, the second reason for this document is to make it explicitly impossible for either the President or the Congress to avoid the consequences of their actions. Ladies and Gentlemen of the Congress and Mr. President, hopefully this time you can be held accountable.

This presentation is divided into several sections. The first section will examine the paradigm for political science presently in operation in the United States. The second section will discuss why data and claims made by the Executive Branch, and most specifically the President, cannot be accepted at face value. The third section will attempt to uncover the underlying philosophy of the President's plans. The fourth section will make overall predictions for the plan and provide empirical and theoretical support for these predictions. The final section will focus specifically on military spending and will discuss how the President's plans will cost American lives.

THE PARADIGM

The word paradigm, made popular by Thomas Kuhn's ***Aspects of Scientific Revolutions***, refers to a general world view which shapes and defines people's perceptions. In biology, for example, biological evolution is a paradigm and in physics, the Theory of General Relativity fulfills a similar role. Paradigms help to organize people's thoughts but also may define the very kinds of questions they ask and knowledge they seek. For example, it made little sense for 18th century biologists in Europe to ask how organisms evolve since their paradigm of immutable species precluded even the concept of evolution. Paradigms exist in all aspects of human life and thus in political, as well as natural, science. In what follows, I hope to demonstrate that a fundamental shift has occurred in the paradigm we call the 'America Dream' and explain the consequences this shift has for American political and economic systems.

Until the 1930's, the American Dream, however imperfectly implemented, was a process. This process can be best characterized as the belief that individuals should be able to pursue their goals and realize them to the best of his or her own ability. The underlying assumption was that each individual should be able to succeed based solely upon their own merit, ambition, and effort. Other considerations were not supposed to matter. Clearly, this Dream was imperfectly realized. Slavery existed for a goodly portion of American history and women were suppressed. American

native populations were systematically exterminated. Still, the Dream as a goal and fundamental objective to be fought for remained intact. Indeed, one could well argue from Abolitionists writings that it was the American Dream as a process that led them to violently oppose slavery - by that criterion, it was unAmerican.

Since the Great Depression , a paradigm shift (or revolution as Kuhn might say) has taken place. The common characterization of the American Dream as a 'house in the suburbs' demonstrates that the Dream has shifted from being a process to being an endpoint. From the idea that one's reward should reflect one's effort, the Dream is now simply the reward itself. The American Dream is now wholly and completely materialistic.

There are a number of implications inherent in this paradigm shift. Since the Dream has become simply a reward, there is little or no effort being expended in considering how the reward is to be obtained. That is part of the process and the process is no longer important. If you get your house by earning it or being given it by the government does not matter - with the new American Dream if the reward is the same, the manner in which it is obtained is irrelevant. This leads to an extreme belief in the 'ends justifying the means'. From the Wall Street insider trading scandals to the demands of some unions for high pay with little effort, from sports players' and CEOs' salaries which are only loosely tied to performance to the plethora of rights to housing, to jobs , to health care, etc., which are completely isolated from any individual effort or merit, this paradigm has exerted a pervasive influence on American society. Even two mass movements which initially appeared to operate on the previous process-based paradigm, the civil and women's rights movements, have shifted to the new end-based paradigm.

Recall that both movements were originally formed to oppose attitudes, laws, and programs which discriminated against African Americans and women in order to insure fair and impartial access and opportunity based upon merit. Neither movement could be so characterized at present. Equality, and not equal opportunity, are the goals of both movements and if obtaining what is perceived as equality, characteristically in terms of materialism, requires the very kinds of discrimination such movements originally opposed, this is not seen as in any way unjust. For example, when applying for a position at Swarthmore College several years ago, I was told over the telephone that I was "the wrong race and sex". If I had been female or African American, this conduct would have been deemed outrageous and illegal. Being a white male, however, this is simply business as usual in American academia. The ends justify the means is indeed the modern American paradigm.

This paradigm shift also has profound implications for the role of government. As a process, the American Dream could expect little from governments other than protection. If a person's reward was based upon their own merit and effort, then the role of government is basically to insure people sufficient freedom in which to express their own abilities. The government could not force anyone to express their abilities although by providing high quality educational opportunities and job training, it could increase the chances of a person's discovering his or her own potential. However, it was up to that individual to actually express that potential in order to succeed. This was the inevitable trade-off - in return for the freedom and right to be judged upon one's own merit and effort, one became responsible for the results of that effort and merit. The results could be either positive or negative but the individual was forced to be responsible for them. The extreme moral courage this paradigm requires is characteristic of the process-based American Dream.

The end-based paradigm is far different. Since the Dream can now be realized simply by obtaining a materialistic end-point (housing, job, health care, car, etc.), it becomes possible for the government to provide that end-point. The government can now be required to provide each individual, regardless of merit or effort, with equivalent material goods. This is the paradigm which has given rise to the Clinton Economic Plan and the Plan reflects its heritage. The underlying assumption of this American Dream, of course, is that the process by which one obtains the end-point is not important. It is not clear if this fundamental assumption is correct.

WHY STATEMENTS FROM THE PRESIDENT CANNOT BE USED TO EVALUATE THE PLAN

It is possible that the purposes and objectives of the Clinton Economic Plan are exactly those articulated by the Administration. Even if this is true, however, intentions do not always adequately predict results. However, I have good reasons for exercising caution in evaluating the claims made for the Plan by the Administration as well as by those which oppose various aspects of the Plan's implementation. As a research scientist, I am well acquainted with the problems posed by subjective evaluation and opinion, especially when dealing with issues in which there is strong emotional involvement. In addition, American politicians have displayed a marked tendency for revisionist history, especially when considering their own roles and responsibilities. Thus, I can claim that Mr. Clinton's statements with regard to his economic proposals have no predictive validity whatsoever.

Such a strong statement requires justification. I will thus provide two examples. The first example involves the much-discussed middle class tax cut promised on several occasions by the President as a candidate. Mr. Clinton has stated subsequently that the tax relief was based upon faulty numbers and the increase in the deficit exceeded his most reasonable expectations. Unfortunately for Mr. Clinton, then Vice-President Dan Quayle stated during the Vice Presidential debates that his evaluation of the Clinton economic plan led him to believe that tax payers down to

$36,000 per year would be paying higher taxes. The actual number, subject to fairly constant revision, is $30,000. Since both Mr. Quayle and Mr. Clinton were using the same figures, this leaves only two logical possibilities; 1. Mr. Quayle possesses more intelligence and foresight than Mr. Clinton, Mr. Gore, and the entire Democratic economic team; or 2. Mr. Clinton was being purposefully overly optimistic. I suspect even the most ardent supporters of the President would prefer the latter possibility.

The second example involves the President's attack on pharmaceutical companies. The President has contended that the high price of vaccines is the main reason for inadequate vaccinations among the poor. I have been associated with health care professionals and I know of several occasions where free vaccines had to be destroyed because parents would not bring their children to be vaccinated. Insofar as these vaccines and health care professionals had set up within the housing projects themselves (the parents were required to walk a distance of approximately 1/2 block), availability was not a significant problem. Nor was the price - I fail to see how one can get much less expensive than free. Again, there are two logical possibilities: 1. the President is unaware of the real situation and was speaking out of ignorance; or 2. the President was purposefully overstating the case in order to achieve an objective. Nothing I have seen of the President suggests that he is ignorant, so I am forced to accept the latter hypothesis.

In American politics, strict honesty is not practiced presumably because telling the literal truth would insure loosing the contest. When selling yourself as a candidate or your proposals to American public, some leeway is given for hyperbole and unbalanced judgments. This is characteristic of almost all politicians and the fact that Mr. Clinton is extremely adept at such deception is of no particular importance to his chances for success. Indeed, Niccolo Machiavelli would argue that such practices are absolutely necessary for truly successful leadership. What is of importance, however, is that the President's statements cannot be judged as a strictly reliable indicator of his intentions. I must therefore look elsewhere and deduce the underlying philosophy and objectives from the Plan itself.

THE UNDERLYING PHILOSOPHY OF THE CLINTON ECONOMIC PLAN

If statements by the Administration cannot be judged as reliable, by what methods can the purpose of the Plan be ascertained? I will begin by examining the underlying assumptions of the tax package because it is here that the essence of the Plan can be found.

The income tax portion of the package is based upon higher rates of taxation for people as their income rises. This has been characterized as 'progressive' or 'fair' taxation. In what way is this 'fair'? Presumably, people earning more money are worth more in the eyes of those who are paying the bills. In a free market, this translates into public approval for these individuals' talents, abilities, and effort. The worth of these individuals' contributions to society as a whole are initially evaluated by society in terms of its individual members and compensation determined in proportion to that worth. In short, the more money you earn, the more highly valued you are by summary measure of the society in which you live. This is not an evaluation based upon any single objective standard but rather a set of evaluations individually ascertained by those members of the society which are involved in the process. As much as we may deplore that fact that a professional boxer may earn in a single night sufficient funds to keep a valuable medical research program funded for ten years, in a free society it is the individual members who place values on activities. Thus, in a free society, individuals who earn more money must be considered as more talented, more hard-working, and more able than their fellows. In this sense, increasing rates of taxation on individuals who earn more is fair from the point of view 'from each according to his ability'.

Where is this money going? Although some Americans believe that it is dedicated to reducing the Federal deficit, even the most cursory glance at the Plan's specifics will eliminate this erroneous conclusion. The money is, in fact, dedicated to a wide range of social programs. Everything from job training to summer jobs, from job creation programs to other social welfare proposals, are proposed so that the money is not being used to reduce the deficit in any significant manner. In fact, the Plan will raise the Federal deficit by several billion dollars before a predicted economic revival is used to trim the deficit. Any real reduction in the deficit is coming from cuts in the Defense budget and not from raising taxes.

Who benefits from these programs? Presumably those Americans who are in need of some kind of help. Logically, there would be no purpose in social programs designed to help the middle to upper class - they were the ones from whom the government obtained the funds in the first place. If the purpose of social programs was to help the middle class, it would be far better, considering the incredible inefficiency, waste, and fraud permeating every level of the Federal government, if the government simply stopped taking their money. I submit that individual are far more careful with their own money, even if it is only $1000, than Senators and Congressmen who cheerfully play with billions of dollars of other people's money. After all, many members of the House can only balance their personal checkbooks with the greatest of difficulty - to expect them to balance the Federal budget is absurd. The beneficiaries of the new programs must therefore be those in need and the programs are designed to provide benefits 'to each in accordance with his needs'.

You may find the phrase ' from each according to his abilities, to each according to his needs' somewhat familiar. Although this idea forms the philosophical basis for the Clinton Economic Plan, he did not originate the concept. Perhaps the ideas were best expressed in a rather

small but significant work entitled ***The Communist Manifesto*** written by two political and economic theorists, Karl Marx and Fredrich Engels. This idea of redistributing wealth can also be considered a natural result of the new endpoint-based America Dream paradigm.

Before I am accused of 'Red-baiting', let me assure you that I am not suggesting that there is any communist conspiracy at the heart of Mr. Clinton's package. Given the wide-spread acceptance of the endpoint-based paradigm, it would have been extremely difficult for Mr. Clinton to propose any other kind of Plan. Indeed, it may well be that Americans in general have lost the moral courage required to maintain a process-based paradigm with its free market philosophy, self reliance, and individual responsibility. President Clinton himself most likely does not recognize that his ideology as expressed in his tax package is essentially socialist/communist, however unevenly applied (I am certain Mr. Marx would not entirely approve). However, to paraphrase Sir Arthur Conan Doyle's famous character Sherlock Holmes, let us examine how well Mr. Clinton's behavior can be explained by this hypothesis.

In certainly explains why he considers increasing taxation with income fair. It explains his antagonism towards business, especially those, such as pharmaceutical companies, which actually make a profit. It explains his desire to nationalize health care. It explains his nearly obsessive desire to create jobs through government activities rather than by supporting private industry. It explains his Plan's actions in increasing government spending on social programs at the exact same time he is trying to convince the American public that the major problem is the deficit. Based upon the actions of Mr. Clinton, his advisors and supporters and based upon the inherent assumptions and fundamental philosophy expressed in the President's economic plans, I can come to no other conclusion than that the President supports complete government control of the economy, either a limited form of communism or a completely socialist system.

The fact that this idea of redistributing wealth by removing it from those who created it through ability and effort and giving it to those who did not create any of it (after all, it would be stupid to remove wealth from people simply to return it to them) forms the philosophical basis of the Clinton Plan makes the problem of prediction far easier than it would otherwise have been. This is because there have been several empirical experiments with applying this approach: the Soviet Union, several countries in eastern Europe, the People's Republic of China, Cuba to name a few of them. It is possible to gain some insight into the consequences of the Plan's implementation by examining the results of implementing systems with similar philosophical underpinnings. Again, let me stress that the Clinton Plan falls far short of anything Marx and Engels would suggest. In addition, the Plan is not consistent in its application of communist/socialist principles. However, the direction is clear and as the Chinese say ' a journey of a thousand miles begins with a single step'.

It may seem incredible to some of you that a radical change of the American government is underway. First, I must point out that the change in the paradigm described above was a necessary precondition to the development of the Clinton Plan. If the majority of Americans still believed that the process of achievement was more important than the end product, the Clinton Plan would never have come into being. Mr. Clinton is not being exceptionally radical when he proposes shifting control of the economy from individuals to the state - in essence, he is simply doing what the new paradigm requires of him. The results of implementing the Clinton Plan will be as much the responsibility of the Americans who voted for and support him as it is that of the Administration and Congress who put it into action.

As a final note before proceeding with economic and political prediction, I would like to show how easy it will be for the Federal government to assume total control of the economy. First, health care will be essentially nationalized. Care will be rationed and this will provide the means of reward and punishment for those who support and oppose the State, respectively. Once it has been established that the need of people for a program or item justifies the Federal government taking over the industry which provides it, the principle will be used over and over in a variety of circumstances. The argument will be approximately this: It was necessary for the Federal government to take over health care because such care is both essential and people were incapable of obtaining it to the degree to which they wished. Need and desire therefore justify government intervention. The next target will either be energy or food production. Both are essential. Both are needed by people. In both cases, some people will have inadequate means to obtain all they desire. Rather than increase their means of obtaining what they desire through effort (a process approach), people will demand the government simply provide it (an endpoint approach). This the Federal government will be only too happy to do, by essentially nationalizing those industries. Once, the Federal government controls health care, food production, and energy, it is difficult to see how individuals will be able to retain any control over their lives. Any opposition to the State can be easily punished by blocking access to health care, food, or energy. Freedom of speech may be all well and good, but if the State controls your health, your ability to obtain food, and your ability to use energy, what will you say that can have any real effect? In my opinion, the American people are presently purchasing what they perceive as security by selling their personal liberty. In the end, I expect them to have attained neither security nor liberty.

There is yet another way in which such tyranny could be established. This second method is more subtle and will require more time to implement but the final consequences are essentially the same. In this scenario, the Federal government simply increases the number of services it provides by continuing raising taxes on the private sector. With each new program, more people become dependent upon the Federal government and as the private sector deteriorates, there are

fewer and fewer individuals working for themselves and private industry. At a certain point, there will be more people dependent upon government, through either social programs or government employment, than there are earning and creating wealth in the private sector. At that point, the dependent majority will simply vote to keep as much as they want of the working individuals' wealth. In essence, individuals in the private sector will become virtual slaves to the Federal government and the dependent majority. John Stuart Mill in his famous book, ***On Liberty***, issues warnings about the 'tyranny of the majority' and the prospect of people legalizing theft of other people's property was one reason the Founding Fathers originally proposed property ownership as a voting requirement. This scenario could be prevented simply by placing limits on the amount of wealth which can be legally seized by the government in the form of taxes. The fact that the Clinton Administration apparently sees no reason for any kinds of limits on taxation is further evidence that complete control of the economy by the Federal government is a major long-term goal of the Clinton Plan.

PREDICTIONS FOR THE CLINTON ECONOMIC PLAN

The overall results of applying this philosophy are quite clear but I should like to translate them into specific effects on the American economy. My predictions are:

1. The deficit will not be reduced but rather enlarge significantly;
2. The rate of economic growth will be reduced from that observed at present;
3. The quality of goods and services will decrease;
4. Economic productivity will decrease;
5. Real employment (from the private sector) will decrease;
6. State (government created jobs) employment will increase;
7. Inflation will increase significantly (perhaps by 2 to 3 fold);
8. The power of the Federal government will be considerably enlarged;
9. Personal liberty will be restricted;
10. Quality of life for the American people will be seriously eroded

I recognize that these predictions are somewhat vague, but then again, so are the proposed spending cuts endorsed by the House. Without considerable mathematical modeling, the assumptions of which are questionable, I cannot be more specific. These are the general trends which are likely to result from implementing the Plan. Whether or not they emerge or not depends upon three things: 1. the correctness of my hypotheses concerning the effects of government-run economies; 2. the correctness of my assumptions concerning the fundamental philosophical basis of the Clinton Plan; and 3. the logic of my arguments. This is, of course, the reason for this document - to test these factors. Unfortunately, I cannot say I am looking forward to be proven correct should these results come to pass.

Many of these results can be deduced from other implementations of government-run economies based upon communist/socialist philosophy. I personally find it fascinating that both Clinton and Stalin chose to focus on 5-year economic plans- a curious coincidence. However, the Clinton Plan is not a total implementation of communist ideology, it is only based upon that philosophy. An important question is whether or not the fundamental principle of 'from each according to his ability, to each according to his need' is faulty or perhaps previous implementations were defective.

I will present two theoretical argument to bolster the view that it is the principle and not its implementations which are at fault. The first is based upon evolutionary biology and the second upon an approach to the psychology of learning known as operant conditioning.

I will not attempt to delineate the entire theory of evolution by natural selection in this presentation. It will suffice to point out that success in biological evolution is measured by the increase in the frequency of particular genes in subsequent generations. This is accomplished by individuals who behave in such a manner as to maximize the contribution of their genes to future generations. This can be analyzed in terms of cost and benefit. The trick is to maximize the benefit and minimize the cost of each behavior as it relates to increasing gene frequencies. While this does not translate directly into a cost/benefit ratio in terms of the physiological or psychological cost for every behavior, the correlation is fairly high. Animals do not act in ways which increase their costs without some subsequent increase in benefits (at least in genetic terms). How does this relate to 'from each according to his ability, to each according to his needs'?

The assumption of that phrase is that each individual receives whatever is adequate and necessary for survival and no more. The accumulation of wealth is prohibited. What is the natural response to this? Each behavior or expression of effort carries a physiological cost. The more effort expended, the higher the cost. However, the maximum of benefits obtainable is fixed and does not increase. Therefore, the biologically logical approach is to put forth the absolute minimum amount of effort. Since the benefits are equivalent no matter what the effort, and increasing effort increases costs, personal ambition will be abolished. One might argue that only if everyone worked together selflessly, the mutual benefits would increase. There are many problems with this naive evaluation. For example, worked together on what? For what purpose? In what direction? What is beneficial and what is not? The only way such a philosophy would be biologically rational would be if all people were more or less identical. Some insect societies work fairly well in a communistic sense because of high genetic relatedness among the members and in

some societies, a rather strict caste system. Death of an individual honey bee is a rather meaningless event to the hive. I would argue that to impose a communistic philosophy on human society absolutely requires that individuality be suppressed to mimic an insect-like state and that this is probably impossible in the long run. In the short run, one could probably create a society which sufficiently repressive so that individuality will be temporarily submerged. The question Americans must face is whether or not the benefits of a dominant paternal (or maternal) Federal government is worth the cost of loosing the opportunity to express individual differences.

A second approach to understanding the effects of applying Mr. Clinton's version of communist/socialist ideology again uses animal behavior but does not rely on the theory of evolution, which still makes some people uncomfortable. Instead, it examines how animals learn to behave in certain ways. This approach to animal learning, often called operant conditioning, was extensively investigated by an eminent psychologist, Dr. B.F. Skinner. He discovered that particular behaviors could be reinforced by rewarding the expression of the behavior while others could be discouraged by punishing their expression. By combining reward and punishment, an animal's behavior can be modified. While there are limits to the extend of the modifications which can be created and clear species differences, behavioral modification based upon this approach has been extensively used in both animal and human learning. I have examined communist/socialist ideology in biological terms from the point of view of cost and benefit. What about the effects of punishment and reward?

The clear and unmistakable message of the Clinton tax package is that productivity and ability are to be punished and lack of productivity rewarded. The more money one makes, and, as explained above, in a free market-based society this is a clear indication of society's judgment on your ability and productivity, the more taxes one pays. In short, the more productive you are, the more punishment you will receive. And what of the social programs, which are primarily based upon need? The more needy you are, i.e., the less productive, the more reward the government will generate for you. The message of the Clinton tax plan is then clear: the less you do, the more reward you will receive and the more you accomplish, the more punishment you will be forced to endure. The tax package is basically a behavioral modification program designed to decrease productivity. I would argue that all communist/socialist-based economic systems employ the exact same approach to modifying behavior, which is one reason why productivity inevitably falls when such systems are implemented.

The Clinton Plan is not, however, consistent in its application of this ideology. There are investment plans and support for education and small businesses which appear, on the surface, to buttress private enterprise. I have little doubt that the Administration has designed them with that very intention. I am also impressed with the emphasis on education, job training, and welfare reform. However, the influence of the Federal government in these plans is so pervasive that even these proposals will most likely increase dependency rather than reduce it. The bottom line is this: if the American public wishes to be guaranteed jobs, health care, and other benefits, payment will be required. Unfortunately, I do not believe that most Americans actually understand the exact nature of that payment. Higher taxes is not by itself the major requirement - a loss of personal liberty and the opportunity to express one's individuality is the real cost.

A COMMENT ON THE CLINTON PLAN FOR DEFENSE AND NATIONAL SECURITY

In predicting the effects of the overall Clinton Economic Plan, empirical experiments involving applications of Clinton's underlying philosophy (communist/socialist) were available. While the Clinton Plan is not consistent in its application of this ideology, these experiments were valuable in helping to ascertain likely results by examining more complete implementations. It is quite useful that empirical experimentation is also available concerning the likely results of the massive and rapid reductions in Defense spending, i.e., the experiences under President James Carter in the 1970s.

The Carter years were marked by a severe loss of prestige and security of Americans throughout the world. Although the press has reported that Secretary of State Christopher considered the Iran hostage crisis a 'triumph for democracy', I can only assume that having been neither a hostage or a relative of one of the soldiers who died in the desert affords him a unique point of view. I consider that episode a triumph for incompetence. America was 'held hostage' because it lacked both the will and the ability to prevent or deal effectively with the crisis. Military hardware during the Carter years was often poorly maintained and soldiers were ill-trained compared with the Reagan-Bush years. Compare, if you will, the results of the hostage rescue attempt under President Carter with Desert Storm under President Bush. The difference was between a well-trained, well-equiped, and prepared military and a military essentially left to rot. It is clearly the intention of President Clinton to repeat even more extensively the mistakes of the Carter years with respect to Defense.

Much has been made concerning the end of the Cold War and its impact on Defense priorities. There are several aspects of this perception to consider before spending the 'Peace Dividend'. First, I must point out that the Russian Republic is not sufficiently stable to depend upon that nation not returning to a nationalistic and essentially totalitarian regime. In other words, this may be simply an intermission in the Cold War - the final act may still be yet to come. Second, the threat which resulted in military action in both the Carter and Bush Presidencies did

not come from the Soviet Union. The Soviet Union may be gone, but there are numerous other players in the world. Recall that two very small countries, Germany and Japan, had a rather significant impact on world peace in the 1940s. Recall also that the United States had undergone significant reductions in military preparedness prior to the attack on Pearl Harbor. It could be easily argued that the defensive lapse on the part of the United States and the Japanese attack were at least partially cause-and-effect.

There is also the question of professional and state-supported terrorism. Although this has been reduced due to the break-up of the Eastern Block, the bombing of the World Trade Center demonstrates that terrorism has not disappeared. I do not believe that the fact that the bombing occurred during the Clinton Administration is a coincidence. If I, as an American citizen, perceive the Administration as weak, indecisive, and incredibly naive with respect to foreign policy, how do you think foreign government and terrorist groups perceive Mr. Clinton? If I believe that the Administration lacks the courage to use force in the face of either aggression or terrorism, what do you think professional terrorists and dictators will believe? If terrorist groups see the United States military gutted and demoralized, results that the planned cuts will inevitably achieve, do you think they will fear retribution? Will the nations which support them fear it? Undoubtedly, the answer is no.

One of the factors which prevented the use of chemical and biological weapons during the Gulf War was the efficient command of the skies achieved by the coalition forces. Similar considerations prevented Hitler from using such weapons during the latter stages of World War II. Biological and chemical weapons can be made extraordinarily powerful and extremely inexpensively. You may not know this, but as professional biologist, I can assure you that this is the case. If the United States is perceived as lacking either the will or the ability to defend itself with overwhelming force, it is virtually certain that these weapons will be used. And Americans will die.

Let me make this prediction absolutely clear so there can be no mistake or misinterpretation. It is my opinion that if these Defense cuts are made in the manner specified by the Clinton Administration, Americans will suffer and die as a result. American civilians will die as a result of terrorist attacks. And American soldiers will die due to insufficient support, inadequate maintenance, lack of spare parts, and the accidents which will inevitably result. These Defense cuts will kill American civilians and soldiers.

CONCLUSION

This critique of the Clinton Plan is clearly inadequate. Alternatives, although they exist, have not been presented. However, my purpose was not to try and prevent implementation of the Plan, which I consider inevitable. Rather I hope to test my hypotheses concerning the Plan and prevent the invention of responsibility-avoiding excuses by the President and Congress should my predictions in some measure come to pass. Excuses, however, may not be necessary even if these predictions are correct. Americans seem to have decided that the costs of personal liberty are not worth freedom's benefits.

It is my belief that the Clinton Plan is the inevitable consequence of the endpoint-based paradigm of the American Dream. Americans may well have lost the three necessary attributes required of a people to be free: 1. moral courage; 2. intelligence; and 3. courtesy and mutual respect. It is unfortunate should this turn out to be the case. In all of history, various governments have promised endless utopias and never once have they delivered on their promises. I fear than when it comes time for the American people to really pay the piper, they will find the dance far more difficult than they expect.

A final note. The opinions and arguments expressed herein are my own and solely my responsibility. They do not necessarily reflect the views of any other person or institution with which I am associated.

JOHN O. NORQUIST
MAYOR

OFFICE OF THE MAYOR
MILWAUKEE, WISCONSIN

Statement of
JOHN O. NORQUIST
Mayor
City of Milwaukee
to the
Committee on Ways and Means
U.S. House of Representatives
March 23, 1993

Thank you for affording me this opportunity to comment on President Clinton's proposal to expand the federal Earned Income Credit (EIC).

Few federal programs are as effective as the federal EIC in achieving socially and economically desirable goals. The EIC is targeted on those who most need help: America's low-income workers. It encourages work. It encourages the pursuit of full-time work. It encourages the pursuit of higher paying jobs. It makes AFDC and other forms of welfare less attractive, as it makes self-sufficiency more attractive. It provides workers with discretion as to how to receive and use the incentive offered to them, thus promoting self-respect and good financial planning.

In recent years, the federal EIC has become a vehicle for pursuing additional laudable goals. The creation of a higher credit for working parents with two children, for instance, began the process of turning the EIC into a mechanism for making work pay enough to get above the federal poverty line.

As I write this statement, I have not yet had the opportunity to review the details of President Clinton's proposed expansion of the federal EIC. I am familiar, however, with the broad outline of the changes that the President is proposing.

<u>I fully support President Clinton's EIC proposal. I strongly encourage the Ways and Means Committee, and in due course Congress as a whole, to implement the President's plan.</u>

The suggestions that follow for expanding the federal EIC are entirely consistent with the President's plan. To the extent that they may differ from the yet-to-be disclosed details of that plan, the differences are not fundamental. They reflect, rather, either my current lack of familiarity with the specifics of the President's plan or my views as to how--following implementation of the President's plan--the federal EIC should be further expanded.

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Before going into detail, let me summarize my background with the federal EIC. Approximately four years ago, my administration initiated Milwaukee's EIC Campaign, one of the first local efforts in the nation to inform eligible workers about the EIC. Launched as a joint effort with the Greater Milwaukee Committee and a local community-based organization called Congress For a Working America (CFWA), the EIC Campaign has been successful in increasing worker awareness of--and utilization of--the EIC. Several years ago, formal responsibility for the EIC Campaign was transferred to CFWA.

My administration, again working with CFWA, was also successful in helping to persuade the State of Wisconsin to create its own "supplemental" EIC. The state EIC was the first in the nation to be both refundable and adjusted for family size. It provides a credit equal to 5% of the federal EIC to a worker with one dependent child, 25% of the federal EIC in the case of two children, and 75% of the federal EIC in the case of three or more children. For tax year 1991, 153,194 Wisconsin tax filers received a total of $27.7 million in state EIC payments.

Based on my work over the last five years in shaping Milwaukee's EIC Campaign and persuading the State of Wisconsin to enact a supplemental state EIC, I recommend the following:

1. **The federal government should create as part of its expanded EIC program a new "worker's supplement" for all low-income workers--regardless of whether they have children--in order to make low-paying work itself more attractive.** President Clinton's proposal to create an EIC for childless workers is the first step in this direction. At this point, I don't know how large this new EIC will be or how it will be structured. In the absence of an increase in the federal minimum wage, I recommend that you ultimately set the "worker's supplement" at $2,000 per year. (If the federal minimum wage is raised, this new EIC could be less.) A person working full-time and year-round at the current minimum wage (i.e., 40 hours per week for 50 weeks per year at $4.25 per hour, generating total earnings of $8,500) would thus have a total income of $10,500 (i.e., $8,500 earnings plus the $2,000 supplement). This seems to be about the amount we need to offer to childless workers to make low-wage jobs minimally attractive.

2. **The federal government should raise the current EIC maximums for workers with one and two children to higher percentages of earnings--and should create a new EIC category for workers with three children with an even higher percentage of earnings--in order to ensure that virtually all persons**

working full-time and year-round at the minimum wage get above the federal poverty line.
President Clinton's proposal to raise the current federal EIC maximum payment is a major step in the right direction. At this point, I don't know exactly what that increase will be or whether it will include a new, three-child, EIC "bracket." My recommendation is to:

-- Set the current one-child and two-children federal EIC maximum payments high enough to achieve the goal of getting such workers out of poverty. My best estimate is that (if the new EIC for childless workers is not included in the base) this would mean raising the one-child maximum to 17% of earnings and the two-children maximum to 47% of earnings.

-- Create a new three-child category, and set the federal EIC for that category high enough to get such workers out of poverty. My best estimate is that (if the new EIC for childless workers is not included in the base) the new EIC for workers with three children should be set at 78% of earnings.

3. **The phase-out rates for all earnings supplements should not be set so high that working more hours or at higher wages is subject to exorbitant tax rates. Rather, to keep the phase-out rate reasonable, the phase-out point should be raised.** Raising the current EIC maximum payment levels and creating an even higher EIC maximum payment level for three-children families, while keeping the phase-out rate low enough to avoid punishing "real" tax rates, requires extending the phase-out point beyond the current $23,050. President Clinton's proposal, which extends the phase-out point to close to $30,000, is a good one.

4. **The federal government should repeal the so-called "wee tot" and health credits.**
These credits cause both equity and administrative problems. I understand the President plans to propose repeal of both of these credits. Again, it is exactly the right move.

5. **Finally, the federal government should improve the EIC's Advance Payment feature.**
Workers will not realize the full benefit of a larger EIC until Advance Payment--that is, receiving their EIC benefits with their paychecks--becomes a more realistic option. Now, fewer than one in 200 eligible workers takes advantage of Advance Payment. While ignorance of the EIC's Advance Payment feature is the principal reason so few use it, I believe that another major barrier to use of Advance Payment is its "all-or-nothing" requirement, i.e., the obligation to claim either all the federal EIC in advance or none of it in advance.

Many workers who know about EIC Advance Payment do not want to claim all of their EIC in advance because:

- They are worried they will receive more EIC than they're entitled to, will owe money back to the IRS, but won't be in any kind of financial position to make the payment.

and/or

- They want to build-up a small "nest egg" to pay for major items, e.g. a car, don't trust themselves to save their EIC Advance Payment for that purpose, and thus use the IRS as their (no interest) savings accounts.

The only alternative, now, is to forego claiming the EIC in advance at all. Given the choice of claiming all in advance or claiming nothing in advance, I believe many workers will continue to opt for nothing in advance.

There is, however, a potential middle ground that would give low-income workers the larger EIC they need as they work, while also addressing their fear about overpayment and allowing them to save. The middle ground is "half and half." I propose that we give workers the option of choosing to receive half of their EIC through Advance Payment and half at year-end. The federal government should also test whether using Electronic Fund Transfer (EFT) mechanisms to implement Advance Payment would work better than the current paycheck-based approach as a vehicle for getting half of the EIC into workers' hands while saving the other half.

Thank you for affording me the opportunity to comment on the federal EIC. Please let me know if I can provide any additional information regarding this vital area of federal policy.

WRITTEN STATEMENT OF
RICHARD A. OVERTON, VICE PRESIDENT CORPORATE TAX
MONSANTO COMPANY

ON REVENUE MATTERS IN
THE ADMINISTRATION'S PROPOSALS FOR
ECONOMIC STIMULUS AND DEFICIT REDUCTION

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

APRIL 6, 1993

My name is Richard A. Overton, Vice President - Corporate Tax of Monsanto Company, a U.S.-based multinational manufacturer of a widely diversified line of high value products such as agricultural products; chemical products, including plastics and manufactured fibers; pharmaceuticals; food products, including a low-calorie sweetener. With sales of about $8 billion in 1992, Monsanto manufactures or markets its products in every state and in about 65 other nations. More than 33,000 people are employed by Monsanto worldwide, with 20,000 located in the United States. Monsanto is a leading exporter with annual export sales of about $1.2 billion. Moreover, the chemical industry is now the largest U.S. exporter as $1 out of every $10 of U.S. merchandise exports are chemicals. In 1992, the industry had record exports of $44 billion and a trade surplus of $16.3 billion.

The purpose of my testimony is to provide the Ways and Means Committee with Monsanto's views on President Clinton's Proposals For Economic Stimulus and Deficit Reduction.

Monsanto heartily applauds President Clinton and Chairman Rostenkowski for their leadership in the difficult task of seeking solutions to the federal deficit. The federal deficit is important and must be reduced, however, deficit reduction should be achieved principally through spending cuts and not tax increases. If significant new taxes are necessary, then Monsanto would favor a Value Added Tax (VAT) and specifically the European style credit invoice method VAT. Any new taxes should only be used to reduce existing taxes or applied towards deficit reduction and not increased spending.

Monsanto shares the Administration's concern for creating new and productive jobs, however, Monsanto believes that the best alternative for increased employment is principally through private investment. As government takes money from the private economy to fund public works programs, private employment falls. Moreover, such public works jobs are often temporary and costly. Unless businesses are investing in U.S. productive assets to create new innovative products, the desired high income permanent jobs simply will not be created. The key to job creation is capital formation for the private sector. The Administration's proposal does not aid capital formation as the net impact on business is a $113 billion tax increase over the next five years. Taking money from businesses -- which also represents savings -- and transferring it to government for deficit reduction (forced saving) does not add to the overall U.S. savings rate. It simply transfers money from private savings to public savings.

With respect to the stimulus package, given the current economic recovery, the new spending stimulus does not appear necessary.

Monsanto's overall views on President's Clinton's corporate revenue proposals can be summarized as follows:

(1) Monsanto is opposed to an Energy Tax. However, if enacted, it should contain an exemption for energy not used as a power or fuel source, such as hydrocarbon and electrical feedstocks used as raw materials in the production process.

(2) Corporate Tax Rates, including Alternative Minimum Tax Rates, should not be raised. As an offset, Monsanto would eliminate the proposed Investment Tax Credit.

(3) The Puerto Rican Benefits of § 936 of the Internal Revenue Code should be retained pending a complete review of the Puerto Rican impact including the issue of Statehood. At a minimum, current U.S. tax benefit for existing Puerto Rican Tax Grants should be grandfathered.

ENERGY TAX

Monsanto is opposed to an energy tax as it singles out a narrow segment of the economy for a tax increase. Monsanto believes that taxes are better raised by spreading the burden as broadly as possible. Unless our trading partners pass a similar energy tax, it will place U.S. manufacturing at a competitive disadvantage. Any new energy tax that raises the cost of U.S.-based production relative to that of foreign-based production damages the international competitiveness of U.S. manufacturing. U.S. manufacturing energy-intensive industry, such as Monsanto, that must compete against foreign-based production will be especially disadvantaged by energy taxes. Recent studies indicated an energy tax would restrict the economic growth resulting in decreased employment ranging as high as 610,000 lost jobs.

Because of the chemical industry's high energy usage, the industry has had an ongoing conservation program for many years. Since the first oil price shock in the mid-1970s, the U.S. chemical industry has made considerable progress in improving energy efficiency, with energy consumed per unit of production declining 43 percent since 1974. Monsanto has had similar energy conservation initiatives and since 1974 has done remarkably well in meeting its goal of demonstrating continued improvement towards the reduction of the amount of energy consumed per pound of product manufactured.

However, if an energy tax is enacted, it should apply as broadly as possible to all fuels and collected as close as possible to the point of consumption. The energy tax should be border adjustable; that is, imports should be taxed and exports should not be taxed otherwise the tax is on U.S. based industrial production and not consumption. Finally, the tax should not apply to energy used as a feedstock.

Monsanto uses energy principally three ways. First, energy is used as a feedstock. For example, natural gas is reformed to make ammonia and hydrogen, electricity is used to extract phosphorus from ore, coal is used to make coke and coke is used as a reducing agent in the manufacture of phosphorus. Secondly, energy is used as a fuel for use in boilers for producing steam. Steam is necessary to permit the flow of material through various pipes and valves as it moves, literally, through miles of pipe from the beginning of the production process to a finished product. Finally, energy is required to produce chemical reactions at certain points in the chemical process.

To illustrate, I will briefly describe Monsanto's production of Phosphorus. Phosphorus is an element, and one of nature's basic chemical building blocks. Monsanto sells some elemental phosphorus directly, but use most of it internally for chemical products. Phosphorus is combined with aluminum, ammonia, calcium, potassium, sodium, chlorine, oxygen and sulfur. The resulting compounds ultimately find their way into a broad spectrum of the economy, for example, phosphorus compounds are used in cleaning and sanitizing products, such as automatic dishwashing detergents, hospital laundry detergents, and industrial cleaners. They are also used to make ingredients for other products, including motor oil additives, herbicides, and certain food and dentifrice products.

Very few of these needs can be met in any other way -- there is no substitute for elemental chemical components. And there is no way to extract an element like phosphorus from its ore without replacing the energy that was liberated when the ore was formed through natural oxidation, billions of years ago.

The phosphorus production takes place at Monsanto's mine and plant at Soda Springs, Idaho which is one of only three elemental phosphorus plants in the United States. It annually produces approximately 115,000 tons of elemental phosphorus which is 40 percent of the Western Hemisphere's requirements and about 20 percent of total worldwide requirements. Demand has been declining at a compound annual rate of about 3 percent for the last 30 years.

International competition, especially with China and the former Soviet Union, is an important factor in this business as these producers tend to sell for cash at any price. Consequently, it is virtually impossible to pass along increased cost. Given Monsanto's higher efficiency and quality, it has been able to compete successfully in this global market . . . so far.

The process by which elemental phosphorus is produced begins by mining phosphate rock from the earth. After mining the two primary processes to produce elemental phosphorus are the nodulizing process and the furnacing process. The nodulizing process is a method by which phosphate rock is fused together or "agglomerated" to form a larger rock cluster.

Electric smelting furnaces for the production of elemental phosphorus operate most efficiently when the phosphate rock fed into the furnaces is reasonably uniform in size and has the necessary strength to withstand mechanical and thermal shock. Phosphate rock introduced into the furnaces must be porous to permit the rapid release of gaseous substances from the reaction zone in the furnaces. Because phosphate rock is a fine material, it must be agglomerated to achieve the desired uniformity in size and the desired porosity. Such treatment is essential to the economic and operational feasibility of the electric furnacing process, which produces the elemental phosphorus.

At Monsanto's Soda Springs Plant the agglomeration of phosphate rock is accomplished through nodulizing the rock in kilns prior to feeding it into the furnaces. The nodulizing kiln is an inclined rotating steel cylinder lined with refractory brick, which is 15-18 feet in diameter and 325 feet in length.

The phosphate rock enters at the higher end of the kilns and gradually tumbles down to the lower end of the kiln. As it does so, applied heat causes the rock particles to bind together. The heat source in the kilns is provided by a nozzle located at the center of the lower end of the kiln through which fuel composed of combustible gas and powdered coal are jetted under pressure. The combustible gas and coal are ignited as they pass through the nozzle into the kilns, creating a flame of approximately 3,300 degrees fahrenheit causing the phosphate rock to "agglomerate" or to form small clusters of rock fragments that are partially fused together to form nodules.

After mining and nodulizing phosphate rock, the phosphate nodules are blended with coke and silica in the proper ratios and this mix of ingredients is deposited into bins above the electric furnaces. Electric current is introduced into the furnaces through three large carbon/graphite electrodes, approximately 350 inches in length and 55 inches in diameter, which extend down through the ceiling of the furnaces into the reaction zone of the furnaces. The electrodes convey approximately 30,000 to 60,000 kilowatts of electric current.

Inside the electric furnaces the above materials are heated to a molten state. The silica serves as a flux, which ensures that the slag produced in the reaction flows properly and has the most advantageous melting point and electrical conductivity. In the electrolytic process carbon molecules in the coke chemically attract or free elemental phosphorous from the nodulized phosphate rock by attracting oxygen molecules. An endothermic reaction occurs which releases elemental phosphorous in gaseous form from the phosphate nodules. The carbon that is contained in the coke and in the carbon electrodes combine with the oxygen molecules that are released from the nodules of phosphate rock to form a furnace gas. The furnace gas containing elemental phosphorous rises to the top of the furnaces and exits through a pipe. The furnace gas is treated to remove dust and sent to condensers where the elemental phosphorus is converted into a liquid for collection and storage in tanks.

The principal use of the electrical energy is to break the molecular bonds. Essentially, the electrical energy is needed to reverse the thermodynamics of the natural formation of the phosphate in the ore. Massive amounts of energy are injected into the phosphate rock to convert it back to elemental phosphorus. There is no way to extract an element like phosphorus from its ore without replacing the energy that was liberated when the ore was formed through natural oxidation. The electrical energy is converted to chemical energy which becomes stored in the elemental phosphorus.

The plant's energy costs, which account for 40%-50% of the total production costs at the plant, run approximately $45 million to $50 million annually. Electricity costs comprise approximately $30 million of the energy costs.

Monsanto's view of the application of the energy tax at the Soda Springs plant would be as follows:

- Plant Boilers. Fuel used in the main plant boilers that supplies heat and steam for the entire plant would be subject to the energy tax. The boiler is designed such that it can be converted to alternate fuel.

- Feedstock. Energy used as a raw material in the production process would not be subject to the energy tax.

Electricity used in manufacturing elemental phosphorus is fundamentally different from normal fuel uses of energy.

- To liberate phosphorus, the oxygen and phosphorus in a phosphate compound called "apatite" must be separated. The chemical formula for apatite is $[Ca_5(PO_4)_3F]$.

- Phosphates are very stable because the elements have a strong chemical attraction for each other as they are very compatible. In fact, apatite is one of the most stable compounds known to man and therefore difficult to separate.

- Apatite decomposition is accomplished in a thermoelectric furnace by mixing it with coke and quartzite and elevating the mixture temperature until a melt is achieved. At that temperature the endothermic (energy storing) reaction can take place and most of the electrical energy used in a phosphorus furnace is stored as chemical potential energy in the resultant product, Elemental Phosphorus or P_4.

- Therefore, the electrical energy used in the phosphorus industry is not being "consumed" in the classical fuel sense, but is rather being stored in the product. There is a fundamental difference between energy that drives a chemical reaction and energy that is being liberated and dissipated as heat such as in a power or fuel use.

Other feedstocks used in manufacturing elemental phosphorus.

- Coal and petroleum cokes are constituents of the mixture that liberates phosphorus from apatite material. Again, this is a necessary component to drive the chemical reaction, and should not be considered a fuel in the classical sense. Its purpose is not a heat source but rather a reacting species.

- The carbon electrodes in an electrothermal furnace are slowly consumed in the reaction that produces elemental phosphorus. However, their purpose is not as a fuel but rather they serve as an electrical conductor.

- Mining. Diesel fuel used to remove the overburden, extract the ore, load it and move it to the mine would be subject to the tax.

- Kiln. Powdered coal and natural gas which are burned in the kiln would be subject to the energy tax.

CORPORATE TAX RATE AND INVESTMENT TAX CREDIT

The stated purpose of the 1986 Tax Reform Act was to eliminate government's role of choosing winners by subsidizing, through the tax law, favored businesses. By removing the tax subsidies, principally the Investment Tax Credit (ITC), and lowering the corporate rate the tax law became more tax neutral between industries and corporations.

The Administration's proposal of raising the Corporate Rate from 34% to 36% and reinstating the ITC is the return to government policies of choosing winners and losers. Due to its incremental feature the proposed change essentially penalizes companies who continued to invest since 1986 and particularly those who invested during an economic downturn. Now that the economic recovery is under way and such investments are starting to pay off they are now penalized by a higher corporate rate. Given the present economic climate, Monsanto does not believe a stimulus in the form of temporary incremental ITC is required.

Moreover, for large corporations, such as Monsanto, the tax cost arising from the higher corporate income rate is a permanent increase while the proposed ITC is only a temporary benefit. It is difficult to understand how a temporary ITC will provide an investment incentive to permanently increase jobs. The permanent tax increase on large business is simply used to provide tax benefits to other taxpayers. It is difficult to understand the economic rationale for this government policy. A recent study by the Tax Foundation confirms the point that in 1989, 5460 large corporations (assets of $250 million) representing only 0.2 percent of all corporate taxpayers paid over 70 percent of all federal corporate income taxes. It is principally the large corporations who are engaged in global competition and in the worst position to pass on the higher tax cost in the form of higher prices that will be effected most. As a result, it is the employees of large corporations who will pay the price of the increased corporate taxes through lost jobs and lower wages. Since 1980, it has been estimated that the Fortune 500 companies have lost some 3 million jobs -- the very type of high paying jobs the Administration is trying to create.

The United States must come to the realization that it can not continue to place a disproportionate and ever increasing tax and regulatory burden on a few large industrial enterprises and expect those enterprises to be viable in a competitive global environment. Instead, the United States should harmonize its tax system, vis-a-vis its major trading partners, with for example, a European style credit invoice value added tax.

As previously stated, Monsanto would forego the ITC in exchange for retaining the 34% corporate income tax rate. If, however, an Investment Tax Credit is to be enacted, then Monsanto presents the following suggestions:

- The calculation of the ITC incremental base period should be adjusted for subsequent business dispositions/acquisitions. This concept is currently contained in the Research and Experiment Tax Credit.

- Capital expenditures for environment cost should also be removed from the base. This has the effect of providing an enhanced ITC for taxpayers, such as Monsanto, who are spending a substantial amount -- about 12% -- of its capital dollars towards making the manufacturing plants pollution free. Moreover, tax credits for environmental expenditures should be permanent since obviously a clean environment is not a temporary goal.

- Finally, for such tax credit to be effective it must not only reduce the regular corporate tax liability but the Alternative Minimum Tax as well.

PUERTO RICO

Monsanto became significantly involved in Puerto Rico in 1985 when it entered the pharmaceutical business through the acquisition of its wholly-owned subsidiary, Searle. Searle began operations in Puerto Rico in 1969, and has grown such that today it has $75M invested in property, plant, and equipment and 527 full-time employees producing a wide range of products with sales totaling some $846M.

Monsanto believes that it is erroneous to view Puerto Rico simply as another unwarranted business tax subsidy to a favored few which should be eliminated for the sake of deficit reduction. Rather, the tax benefits of §936, IRC, were to be an inducement for the Commonwealth of Puerto Rico to attract and retain business. It is not unlike the current Administration proposals with respect to Enterprise Zones since each were meant for economically disadvantaged areas, and designed to provide government inducements to all businesses to create meaningful jobs in such areas.

More importantly, it has worked as the Puerto Rican tax provisions have a long and successful history. The U.S. incentives while in place since 1921 only began to have a significant impact on the Puerto Rican economy in the later 1940s. Prior to 1948, Puerto Rico based its economic development on Government ownership and operation of key industries. In that year, however, the emphasis shifted to the encouragement of private investment. Exemption from Puerto Rican income, municipal, property, and other taxes, under grants of industrial tax exemption became the keystone of an industrial incentive program known as "Operation Bootstrap." This program also included providing plants at low rent, cash grants to cover start-up costs, employee training, and low interest loans. Other non-tax factors made the Island even more appealing for a manufacturing operation; for example, Puerto Rico was within the U.S.

customs territory, eliminating tariff barriers, and Puerto Rico offered a stable political and economic climate, given its close ties with the United States.

Although it is difficult to say exactly how much of Puerto Rico's ensuing economic growth resulted directly from the combination of these incentives, it can be safely said that the combination of U.S. and Puerto Rican tax exemptions were a major -- if not the major -- factor leading to that growth. For about 25 years, Puerto Rico enjoyed almost unprecedented development, with gross national product per capita advancing at an average annual rate of nearly 5%. This is directly traceable to increasing investment in physical plant and equipment, creating jobs and improving productivity. While growth in employment was not as spectacular, the shift in employment was nevertheless dramatic, with the country shifting from agricultural and crafts-type employment to manufacturing and government sector employment, as well as construction.

As a result, in 1989, U.S. mainland companies with subsidiaries operating in Puerto Rico directly employed 113,000 workers, representing 13% of the island's total employment and 72% of manufacturing employment. Jobs in the high-paying manufacturing sector have increased from 55,000 in 1950 to more than 157,000 today. The downstream indirect jobs would substantially increase the number with some estimates as high as 200,000 jobs. Instruments, electrical and electronic equipment and pharmaceutical industries have accounted for 3 out of every 4 new jobs in those Puerto Rico manufacturing industries which have experienced an increase in employment since 1968. Manufacturing comprises 39% of Puerto Rico's Gross Domestic Product compared to 20% on the U.S. mainland enabling workers to move from low-productivity agricultural jobs to skilled, highly productive and high paying manufacturing jobs.

Monsanto's views can be summarized as follows:

- The purpose of §936 was to benefit Puerto Rico. Any reduction in §936 benefits should be viewed in the context of the impact on Puerto Rico.

- Given this perspective, Monsanto questions whether the revenue estimates fully reflect the Puerto Rican impact.

- Finally, serious Puerto Rican Statehood debates are taking place and it seems more appropriate to review §936 in the context of a Statehood issue.

However, if the provisions of §936 are to be changed, Monsanto would have the following suggestions:

- Puerto Rican § 936 income tax benefits should be grandfathered for the life of the existing Puerto Rican Grant since companies such as Monsanto have invested millions of dollars on the assumption that both the U.S. and Puerto Rican benefits would remain in place. It is highly unfair to change the rules midstream -- after the money has been invested. It is Monsanto's view that the governments should live up to their promises. Monsanto would only note, with respect to Enterprise Zones, the government has once again promised inducements and if the governments continue not to deliver on their promises, investors will simply ignore them.

- The Administration proposed a §936 limitation based on wages and Monsanto would urge that any wage-based credit consider total compensation costs including fringe benefits such as medical and retirement costs. In addition, some consideration should be given to the capital invested.

CONCLUSION

Clearly, it is the desire of everyone to ensure the United States maintains a strong economic base capable of creating permanent high-paying jobs. While deficit reduction is an important element in the solution, it is important to remember it is only a single component in a complex series of interdependent government policies. All such governmental policies whether they be Environmental, Trade, Health Care or Fiscal must be viewed in the aggregate and tested against their combined impact on the economy. It is only when these policies are working in concert that the United States can compete in a global economy and provide a high standard of living for its citizens.

TESTIMONY OF NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. Chairman and Members of the Committee:

The National Automobile Dealers Association (NADA) is a national trade association representing over 19,000 franchised new car and truck dealers holding more than 35,000 separate franchises. The primary business of NADA members is the retail sale of new and used motor vehicles, both foreign and domestically produced. Our dealers also are engaged in automobile service, repair, and parts sales.

On behalf of domestic and import car dealers alike, NADA supports repeal of the luxury tax on all products as part of the legislation to implement President Clinton's proposals for public investment and deficit reduction. We believe the luxury tax was ill-conceived, discriminatory and counter-productive. It isn't "soaking the rich," it's adding an impediment to car sales which is the last thing we need in this economic climate.

When the luxury tax was enacted in 1990, those items considered "luxury goods" were cars, furs, airplanes, yachts and jewelry. With regard to cars, the law provides that purchasers of vehicles retailing for more than $30,000 must pay a 10 percent tax on the amount in excess of $30,000. When Congress imposed this tax, it was ostensibly to raise revenue and at the same time respond to the situation in the Persian Gulf. The bill was developed hurriedly behind closed doors with almost no involvement by the Congress as a whole, and members had very little knowledge of what the bill contained.

Since enactment of the law, Congress reconsidered the wisdom of the tax and proposed to partially repeal it. The two tax bills (H.R. 4210, H.R. 11) vetoed by President Bush in the 102nd Congress included repeal of the luxury tax on all products <u>except cars</u> and indexed the $30,000 threshold for autos to the rate of inflation. The decision by Congress not to repeal the tax on cars was justified on the basis that cars "raise a lot of money."

Consequently, the whole issue of luxury taxes is back on the table in 1993. NADA supports repeal of the luxury tax on all products. It is unjust for Congress to single out one industry to bear the burden of this tax. If Congress moves the same repeal package again, a very basic inequity exists. A $300,000 yacht, a $250,000 diamond necklace, and an $80,000 fur coat will then not be considered luxury items, but a $31,000 car will be. This is a totally foolish policy and should clearly be changed.

The tax was originally enacted to collect more revenue from the affluent. However, in the real world the tax has become a negotiating element in the retail sale of the automobile. A potential customer will generally bargain with the dealer to pay a portion or all of the tax. In order to make the sale, the dealer will many times have to submit to the customer's demands. While the tax was designed to be paid by the "rich", in practice much of the tax is being paid by the small business automobile dealer. This hurts. Between 1989 and 1992 net dealership profit has fluctuated between 1.0 and 1.4 percent of total sales. This period represents one of the lowest profit levels ever. The further reduction of these profit margins which occurs when dealers are forced to pay "luxury" tax is a significant problem to dealers which was never intended by the taxing committees.

Equity and rational policy considerations demand that the tax be repealed. However, we know that tax legislation is not always driven by equity and rational policy considerations. It is driven by revenue concerns. For that reason, we are aware that repeal would require revenue replacement. At the present time we are actively seeking an acceptable revenue offset. We believe that we will be successful. However, in the event there is a hitch in our efforts, the automobile dealer still needs relief. At the very least, the tax must be taken out of the showroom. If the tax on automobiles is continued, it must be collected at the manufacturer level so it ceases to become part of the bargaining process.

We appreciate the opportunity to have our written statement included in the Committee's hearing record and urge the members to address the problems being created by this ill-advised tax.

TESTIMONY OF NATIONAL BASKETBALL ASSOCIATION

This Statement contains the comments of the National Basketball Association ("NBA" or "League") on President Clinton's Tax Program for 1993, with respect to the proposal to reduce the deductible portion of the cost of sporting events tickets from 80% to 50%.

The enactment of this provision of the Program would substantially impair the operation of existing sports teams, would have adverse effects upon the general economy (specifically the economies of major cities) and would deprive many people of the ability to enjoy viewing professional sporting events.

In addition, the NBA believes that this provision of the Program is unnecessary to protect the tax revenue because any alleged abuse in this area is controllable under the existing law and auditing procedures carried out by the Internal Revenue Service. Further, based on a survey of the NBA teams, if the proposal is adopted, businesses are likely to reduce their entertainment expenditures; therefore, any federal tax revenue gained by reducing the deduction would be offset by a corresponding tax revenue loss at both the federal and local level resulting from a decrease in the income of the teams, concessionaires, restaurants and others. In fact, because of the multiplier principle, discussed below, the revenue loss attributable to the proposed reduced deduction could far surpass any direct revenue gain, thereby resulting in a significant negative impact upon the economies of our cities.

Specifically, the following comments are material with respect to this proposal:

THE PROPOSED LEGISLATION WILL ADVERSELY AFFECT THE ECONOMIC VIABILITY OF THE NBA TEAMS AND RELATED BUSINESSES

The NBA teams rely heavily on game attendance for their revenues. In the NBA's 1991-1992 season, revenues from receipts at the gate totalled approximately $403 million and constituted 46% of the NBA's total revenues. About 62% of this total ($250 million) comes from tickets purchased by businesses, both large and small. The percentage of season tickets sold to businesses is even greater than 62% as individuals often find it difficult to afford the expense of attending every game of a particular team. Season ticket sales are essential to the operation of a sports team because they represent known amounts of income that enable the team to budget its expenses (including salaries) for the next season. It is highly unlikely that businesses' season ticket purchases could ever be replaced by individuals' season ticket purchases because of the substantial outlay required for each season ticket.

Based on information supplied by the NBA teams, if the deductible portion of the cost of sporting events tickets is reduced, the loss to the teams on ticket sales to businesses (after taking into account those lost sales that would be recovered by sales to others) will be approximately $40 million. For the most part, rent and other major costs of operation in a sports arena are "fixed" expenses, with the largest portion being players' salaries. As a result, any attempt by the teams to recoup the loss in ticket sales to businesses may well entail raising their ticket prices. Higher ticket prices consequently would likely foreclose attendance to a great number of basketball fans who normally purchase inexpensive or medium-priced tickets.

Further, the law of diminishing returns limits the extent to which teams could raise ticket prices, thereby limiting the income that teams could recover by increasing their ticket prices. Any significant reduction in the teams' income would seriously jeopardize the teams' ability to hire qualified players and pay their extremely high, competitive salaries. Any loss in the quality of the games would further reduce attendance and

ticket sales by an even greater amount. Such reduced ticket sales might even threaten the financial viability of some teams.

Moreover, each team provides an operational base for a host of related enterprises, such as refreshment concessions, souvenir stands, etc. A decrease in game attendance will have the direct effect of decreasing sales in these ancillary businesses. It is estimated that the loss of concession sales due to a reduction in business patrons alone will amount to approximately $6.6 million if the proposed change in the deductible percentage is enacted. The total loss in concession sales is likely to be even greater because an increase in ticket prices would also cause a drop in the attendance of non-business spectators. As with the teams themselves, these concessionaires can little afford such a substantial drain on their income.

THE PROPOSED LEGISLATION WILL ADVERSELY AFFECT THE COMMUNITY AT LARGE, ESPECIALLY THE MUNICIPALITIES AND SPORTS FANS

To fully appreciate the consequences of the proposed legislation, it is necessary to view its impact beyond the narrow scope of the sports industry and to examine the effect on the community at large. In addition to promoting ancillary enterprises within the industry, as discussed in the previous section, the member teams of the NBA are also inter-related with the municipalities in which they play and with various other industries. The effect of the proposed legislation on these other industries and on the industries which they in turn service would be substantial. In economic terms this is known as the "multiplier principle" and stands for the proposition that if the subject enterprise and the people involved therein are injured, other enterprises who derive income from the subject enterprise will also be hurt, and all enterprises that service these secondary enterprises will be hurt, and so forth.

As applied to the NBA, the President's proposal would trigger the multiplier principle, resulting in overall losses to the sports industry and to the national economy of many millions of dollars. Generally a business person attending a basketball game to entertain a client will plan an entire evening around the game, including dinner, transportation to and from the arena and often some activity after the game. All these activities generate income to the providers of these ancillary services who then have more money to spend and who, in turn, generate more income for those servicing them and so on down the line. The non-business fans who attend games purely for their own enjoyment also generate ancillary revenue by using public transportation or parking facilities and by purchasing food and other items before and after the game, thereby providing the suppliers of these items with more money to spend on their needs.

Viewed in this light, the proposed reduction in the deductible percentage of the cost of sporting events tickets will have severe consequences. Using parking at basketball games as an example, the NBA teams estimate that a reduction in business customers alone would cause a loss of approximately $2.2 million of revenue to municipal and private parking facilities. Applying the multiplier principle, the owners of parking facilities and their employees, in turn, would have that much less to spend on their needs, thus forcing the suppliers of such needs to cut back on their services and on their expenditures. This same analysis also applies to taxis, public transportation, food establishments, hotels, etc., and results in enormous reductions in expenditures.

Concern over the adverse effects of the proposed provision is echoed by government officials of every major metropolitan area throughout the country. Not only do professional sports teams provide an instant source of revenue for these municipalities but they also generally give a boost to

the local economy by, for example, providing thousands of non-sports jobs in the community. If the proposal became law, municipalities are likely to suffer as a result of a general reduction in the economy caused by a decreased demand for services and subsequent job loss. In addition, these local governments would be injured directly by a loss of revenues generated through sales and excise taxes now collected on the items of expenditures, such as ticket sales, concessions, parking and other miscellaneous receipts, which would be reduced.

Moreover, about half of the NBA teams are tenants in municipally owned or financed arenas. Because many arena rentals are based on a percentage of revenues, a reduction in ticket sales would mean a direct loss of revenue to local governments from the operation of such arenas. Concession and parking revenues retained by municipal authorities are also a direct function of attendance. Further, under the worst scenario, if the proposed provision caused some teams to go out of business, then municipal arenas would lose more than 40 events per year (without even taking into account exhibition or play-off games) and would suffer a substantial loss of rental income from a principal tenant. Such a loss is not likely to be recovered since most arenas would have difficulty finding other activities to book in place of NBA basketball. In addition, an arena's loss of more than 40 dates raises the possibility of the arena itself being forced to close, thus causing even greater losses in rental and tax income to the local government.

The alleged benefactors of the proposed legislation, the non-business spectators whose tickets are not tax-deductible, will suffer along with the teams, the providers of services and the municipalities. As noted earlier, in order to compensate for the reduction in ticket sales to businesses, NBA teams may be forced to raise ticket prices, thereby limiting the number of spectators able to attend a sporting event. If the number of spectators declines, then the amount they spend on related activities will also be reduced. Under the multiplier principle analysis, all the dependent industries and their employees in turn will be injured as a consequence. In addition, the ultimate burden of the proposed legislation may have to be shifted to taxpayers through an increase in local taxes to compensate for the loss of rent and taxes payable by the city's professional sports teams. The business purchaser of sports tickets would thus be denied a deduction for a substantial portion of a legitimate business expense, but ironically the cost would be borne by the ordinary taxpayer who may no longer be able to attend the sporting event at all.

TICKETS TO SPORTING EVENTS SERVE A REAL BUSINESS NEED AND ARE NOT SUBJECT TO THE SAME ABUSES AS SOME OTHER FORMS OF ENTERTAINMENT

There is no basis for discriminating against ticket purchases relative to other legitimate business expenditures which are fully deductible, such as advertising expenses or travel expenses on a business trip. Traditionally, our tax system has not allowed deductions for purely "personal" expenditures, and the NBA does not advocate deductions for such expenses. However, as long as a ticket expense is incurred for a legitimate business purpose, the factual determination of which is similar to dozens of other determinations encountered by the IRS, the taxpayer should be permitted to deduct that expense to the extent allowed under current law. As a result, there should be no basis for distinguishing between a business's deduction for sporting events tickets and for any other legitimate business expense, notwithstanding the level of personal enjoyment derived from the business entertainment activity.

Businesses' purchase of sports tickets serve various legitimate business purposes. Basketball tickets are often used as a promotional device for companies that offer free tickets

with the purchase of items by their customers. Industries employing large labor forces frequently give away tickets to sporting events as incentives for more efficient work and for the promotion of better employer-employee relations. In addition, a sporting event is an excellent place to go after a substantial business discussion or to prepare for the negotiation of a business transaction. Businesses are aware that using basketball tickets in the manners indicated has a positive effect on their business activities, and this is evidenced by the fact that more than 60% of those attending sporting events do so for business purposes.

CONCLUSION

In summary, the proposed provision is an unwarranted and ineffective means of attempting to generate additional tax revenue. The proposed reduction in the business deduction for the purchase of sports tickets would impose undue burdens on sports teams and on the general economy. There is no justification for distinguishing the purchase of sporting event tickets from other legitimate business expenses. The result of such action could substantially reduce the economic viability of professional sports teams, seriously injure local governments and a myriad of ancillary enterprises, and greatly reduce the number of professional sports patrons. The NBA urges rejection of the proposed provision in order to avoid these adverse consequences.

If any material is submitted to the Committee in connection with the proposed Program which may require further comment from the NBA, the NBA would appreciate the opportunity to make such comment.

Respectfully submitted,

NATIONAL BASKETBALL ASSOCIATION

Statement of

National Clay Pipe Institute

by

E. J. Newbould, Corporate Counsel

To

Committee on Ways and Means
U. S. House of Representatives

April 2, 1993

I. Introduction

The National Clay Pipe Institute (Institute) is a trade association composed of all of the U.S. manufacturers of vitrified clay pipe. We have factories located in Arizona, California, Indiana, Kansas, Ohio and Texas. For many years, we have supplied to the national water pollution control program a high quality sanitary sewer pipe of unrivalled endurance.

The pipe material market is fiercely competitive. We compete with other rigid materials such as concrete pipe and ductile iron pipe. But, all things considered, our major competitor is plastic pipe. While we are convinced of the superiority of performance of our product over any of the plastics, it is a fact that, measured by price alone, plastic pipe is invariably cheaper than clay.

Now, the new Administration proposes to tax the natural gas used as a fuel to manufacture clay pipe and simultaneously to exempt the natural gas used as a non-fuel feedstock to manufacture plastic pipe. Should this tax be enacted as proposed, the effect on the clay pipe industry would be calamitous. Already confronted by a wide price disparity, the industry would be forced into an untenable position. It is no exaggeration to state that, where many competitors have tried and failed, our own government would have succeeded in destroying this industry as it exists today.

II. Objectives of the Broad-based Energy Tax

The Department of Energy (DOE) has declared that the purposes of the energy tax include the following: revenue-raising; improvement of the environment; the conservation of energy and the limitation of adverse competitive effects domestically.

Our industry subscribes to all of the DOE objectives. We concur in the need for revenue-raising to reduce the federal deficits. We strongly favor recycling, where appropriate, to improve the environment. We have long since adopted new techniques to conserve energy to the extent that an independent study[1] has concluded that, compared to the production of plastic pipe, the manufacture of clay pipe consumes less energy. And, finally, we offer below practical suggestions to the Committee whereby the adverse competitive impacts of the differences in

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[1] Illinois Institute of Technology Research Institute, "Energy Audit of Vitrified Clay Pipe Manufacture"

taxing fuel use and exempting non-fuel use can be minimized, if not eliminated.

III. Energy Use as a Fuel or as a Non-Fuel

The Institute has not been able to identify any logical reason for the distinction which imposes taxation on the use of petrochemicals as fuel and withholds taxation from the non-fuel use of petrochemicals used as feedstocks. A spokesperson for the Department of Energy advised that, since in the latter case, "the petrochemical was not being used as an energy source and since this tax is a tax on energy, the non-fuel use feedstocks are exempt." This explanation failed to clarify the matter for us - insofar as the plastics are involved.

The non-fuel use of the petrochemicals has the effect of locking into the final plastic product the potential energy of the petrochemicals. That energy, until released through recycling, remains just as unavailable as an energy source as the petrochemicals used as a fuel.

We conclude that the non-fuel use distinction as proposed by the Administration is arbitrary and should not include an exemption for the plastics. Rather it should authorize a rebate allowance for those plastics capable of recycling. For one example, France is successfully recycling polyvinylchloride (PVC) used in bottling mineral water.[2]

IV. Recommendation to the Ways and Means Committee

The testimony of the Natural Resources Defense Council before this Committee on March 23, 1993, in discussing the treatment of feedstocks[3], is consistent with our position that incentives for recycling plastics should be an essential feature of this energy tax legislation.

The Administration's unlimited non-fuel tax exemption for plastic materials should be eliminated. Instead, tax rebates should be permitted, but only to the extent that the potential energy in the feedstock is actually returned to the energy mainstream via the recycling process.

V. Benefits of Rebating Taxes for Recycled Plastics

Should the Committee accept the foregoing recommendation, several benefits would flow from such approval:

(a) The overall anticipated revenue would increase, since not all plastic products lend themselves to recycling,

(b) Strong incentives to recycle and to improve recycling procedures would be introduced,

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[2] Chemical Week Magazine, November 18, 1992, p. 42: "In France, where PVC is used to bottle mineral water, a national recycling program has meant the product has generally achieved a much higher level of environmental acceptability."

[3] Lashof, page 4 of Statement by NRDC.

(c) The Committee would strengthen a fundamental principle of fairness to taxpayers: any exemptions from a broad-based energy tax should carry a duty to respond with equivalent concern for the nation's environment, and

(d) The Committee would ensure equity in tax treatment for the domestic competitors of plastic products.

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STATEMENT OF JOSEPH E. LEMA
VICE PRESIDENT FOR TRANSPORTATION
NATIONAL COAL ASSOCIATION

on

PRESIDENT CLINTON'S PROPOSAL
TO INCREASE THE FEDERAL
INLAND WATERWAYS FUEL TAX

for

MARCH 1993 HEARINGS
ON PUBLIC INVESTMENT AND
DEFICIT REDUCTION

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Introduction

National Coal Association (NCA) is the Washington, D.C. - based industry association which represents coal producers and other companies associated with production, distribution, and consumption of U.S. coal. NCA's member companies account for approximately 60 percent of total U.S. coal production. Coal is a major commodity carried to utility and industrial plants and to Gulf Coast ports from which coal is exported to overseas markets, utilizing intermodal rail-barge and truck-barge transportation, with commercial navigation on the nation's inland waterways as a vital element of the overall coal distribution network. Therefore, the coal industry has serious concerns about President Clinton's proposal to impose an additional fuel tax of $1.00 per gallon on commercial barge traffic using the inland waterways, to be phased-in from 1994 to 1997, and thereafter to be indexed to adjust the tax for inflation. The new tax, added to the existing barge fuel tax, which will rise to 20¢ per gallon in 1993 under present law, would grievously harm the competitiveness of U.S. coal, causing increases in industrial, commercial, and residential consumer rates for electricity, and critical losses in U.S. coal exports and our balance of trade.

Inland Waterways Are Attractive Coal Routes

The importance of commercial navigation on the inland waterways to coal distribution is shown by the fact that, in 1991, commercial, shallow-draft barge tows moved approximately 154 million tons of coal, of which nearly 85 percent was carried to domestic consumers, and about 15 percent was hauled to export terminals on the Gulf Coast at Mobile, Alabama and on the lower Mississippi River from Baton Rouge and New Orleans to the mouth of the river, for transfer to deep-draft vessels. It is noteworthy that about one-half of the coal tonnage moved by inland barge lines was brought to river terminals by rail carriers, and more than one-third was brought by trucks, with the remainder moved to river terminals by conveyor belt systems, illustrating the attractiveness of barge transportation for coal shipments, notwithstanding that coal movements are originated by other surface transportation modes. That attractiveness is underscored by the fuel-efficiency of barge tows, an attribute which results in lower vehicular emissions, both due to their fuel-efficiency, and to their separation from other surface traffic, thereby reducing surface traffic congestion and vehicular emissions related to such conditions. To impose new fuel taxes now proposed would, therefore, not only raise rates paid by consumers of electricity and cause losses in exports, they also stand to be counterproductive from an environmental viewpoint by diverting traffic to less fuel-efficient modes.

The Proposed New $1.00/Gallon Tax Severely Raises Coal Rates

Major waterways coal traffic movements are routed on the Ohio River and its tributaries, with the Ohio River itself stretching 981 miles from its junction with the Mississippi River upstream to its origin at Pittsburgh. Likewise, the 950-mile portion of the Mississippi River below its junction with the Ohio River, the 850-mile portion of the Mississippi River upstream from its junction with the Ohio River, and the 400-mile Warrior-Tombigbee River System upstream from Mobile, Alabama are principal coal-carrying rivers. NCA estimates that, typically, the proposed new $1.00 per gallon fuel tax would have severe implications for coal rates. Examples of a/ selected coal movements and the effects of the new tax are:

- Coal originations on the Ohio River below Cincinnati, having destinations on the Upper Mississippi River:

Average Barge Distance	634 miles
Average Barge Cost-1987	$6.00/ton
Estimated Effect of Tax	+ $1.27/ton
Est. Percentage Change	+21%

- Coal origination on the Ohio River above Cincinnati, having destinations on the Upper Mississippi River:

Average Barge Distance	1300 miles
Average Barge Cost-1987	$13.74/ton
Estimated Effect of Tax	+ $ 2.61/ton
Est. Percentage Change	+19%

- Coal originations on the Ohio River below Cincinnati, having destinations on the Lower Mississippi River from Baton Rouge and New Orleans to the Gulf:

Average Barge Distance	1125 miles
Average Barge Cost-1987	9.04/ton
Estimated Effect of Tax	+ $2.25/ton
Est. Percentage Change	+25%

- Coal originations on the Ohio River above Cincinnati, having destinations on the Lower Mississippi River from Baton Rouge and New Orleans to the Gulf:

Average Barge Distance	1443 miles
Average Barge Cost-1987	$12.93/ton
Estimated Effect of Tax	+$ 2.87/ton
Est. Percentage Change	+22%

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a/ Average barge distances and average barge costs are from a transportation cost analysis of inland waterways shipments reported August 31, 1990 by the U.S. Army Corps of Engineers, Water Resources Support Center in a memorandum to the Inland Waterways Investment Study Advisory Group. Estimated effects of the tax and percentage changes are calculations made by NCA.

Typically, coal produced in eastern and midwestern coal states and carried by barge to utility plants located in the upper midwest from Appalachian and Illinois Basin mines would encounter increases in delivered prices amounting generally to within a range of 4.5-7.5 percent if the proposed new fuel tax were to be imposed. Similar coal supplied to Gulf Coast utility markets and to overseas markets reached from Gulf Coast ports would face increases generally to within the range of 7.0-8.5 percent in its delivered price due to the proposed new fuel tax. Realizing that more than 55 percent of U.S. electricity is generated by burning coal, increases of that magnitude would have serious implications for consumers. Further, the new taxes would be a critical blow to U.S. coal exports which currently account for approximately $4.5 billion annually on the positive side of our balance of trade.

Cost Sharing Of Waterways Funding Must Be Fair and Equitable

After years of debate with regard to cost sharing on the commercially navigable inland waterways system, the Water Resources Development Act of 1986 established a fair and equitable method of funding for waterways projects. NCA was a leader in developing support for those provisions of the 1986 Act which increased the barge fuel tax from 10¢ to 20¢ per gallon in phases from 1986 to 1995, called for fuel tax revenues to fund 50 percent of the costs of waterways construction and rehabilitation projects, and specified that 100 percent of the costs of waterways operations and maintenance by the U.S. Army Corps of Engineers will be borne by the Federal government.

That funding methodology takes into account, appropriately, that obsolete locks controlling commercial navigation on the waterways must be replaced and expanded in barge tow capacity for efficient lockage maneuvers where structural conditions and the traffic demand justify such improvements, and that commercial traffic should share the costs of those projects. On the other hand, commercial waterways users should not be called upon to pay for non-navigation benefits associated with dams and their impoundments, or water pools, including flood control, water supply, hydropower generation, and recreational boating. Similarly, it must be recognized that non-Federal sources bear substantial costs with respect to the provision of intermodal rail-barge, truck-barge, and conveyor belt system-barge uses of the inland waterways system. For example, private sources build, operate, and maintain river terminals that are essential for linking barge tows with other surface freight modes such as railroads, trucking operations, and conveyor belt systems which move commodities, like coal, to the rivers from production points.

Further, railroads and conveyor belt systems are built, operated, and maintained by private entities, and trucking operators and rail carriers provide, operate and maintain the transportation equipment needed to carry commodities to the rivers for transfer onto barge tows. Likewise, states and local government agencies build, operate, and maintain highways that enable trucking operators to have access to the rivers for the movement of intermodal truck-barge cargo. All of the above is evidence that the strategic inland waterways system now has in effect under present law a balanced, fair and equitable method of cost sharing by Federal and non-Federal sources of funding, including commercial waterways users, through an existing barge fuel tax mechanism.

Realizing that barge tow congestion due to obsolete and under-capacity locks causes inefficiencies that are harmful in regard to the delivered price and competitiveness of various bulk commodities like coal, agriculture products, chemicals, minerals, aggregates, and refined petroleum products, with stalled barge tows estimated to incur losses of about $360 per hour while waiting for lockages, it is important to assure that waterways projects are advanced on timely basis in consideration of traffic demand . Whereas the current percentage cost sharing ratios are appropriate, it is desirable periodically to evaluate whether the flow of revenue into the Inland Waterways Trust Fund, i.e. the income from the existing schedule for barge fuel taxes, is sufficient to enable critical construction and rehabilitation projects to be completed commensurate with traffic demand. It is apparent that navigation projects now authorized and in progress are fully utilizing current barge fuel revenues. To ensure that justified projects will proceed in an orderly, timely fashion in the remainder of the 90's and the next decade, NCA believes it is appropriate now to assess the amount of barge fuel taxes required to furnish adequate revenues to be deposited into the trust fund for payment of 50 percent of the costs of waterways projects. However, NCA also believes strongly that the proposal to impose a new $1.00 per gallon tax to fund waterways operation and maintenance by the U.S. Army Corps of Engineers should be wholly rejected.

TESTIMONY OF RICHARD A. LACEY
National Employment Opportunities Network

The National Employment Opportunities Network (NEON) is comprised of approximately 4,500 employers of all sizes, trade associations, community based groups that serve structurally unemployed people, public interest groups and national organizations. For the past three years, the mission of the Network has been to increase and improve the quantity and quality of employment opportunities, especially for those Americans who face barriers to mainstream employment. NEON strongly supports renewal of the targeted jobs tax credit (TJTC) and wishes to thank the Committee for this opportunity to submit written testimony in addition to the oral and written testimony by representatives of the Marriott Corporation on behalf of employers in NEON.

Community based organizations that place structurally unemployed job-seekers work hand-in-hand with employers like Marriott. The NEON office receives a constant and daily stream of inquiries about the status of the targeted jobs tax credit from community based organizations around the country. These groups emphasize the need to restore this program and make it permanent -- that is, stabilize it once and for all -- because TJTC has been a major tool for community based groups to gain and maintain access to employers. They stress that employers' enthusiasm about TJTC provides TJTC-eligible workers a more level playing field in a difficult job market.

Many national and community based groups have pointed out that TJTC has been instrumental in helping employers to overcome longstanding prejudices against structurally unemployed people, such as workers with disabilities. In recent years, representatives of the business community who have testified before the two congressional tax-writing committees have stressed the business rationale for hiring structurally unemployed people with TJTC.

This point is central. TJTC has enabled community based groups to get a foot in the employer's door, and employers have continued to hire -- and even to reach out to -- organizations that place structurally unemployed people eligible for TJTC. Employers experienced with TJTC have demonstrated that TJTC provides the essential cost offset for recruiting, hiring, providing entry level orientation and training, extra supervision, higher health costs, and other hidden costs due to low initial productivity and unfamiliarity with the mainstream workplace and with mainstream fellow workers.

As Marriott and other large, multi-location, nationwide employers testify, TJTC has indeed been responsible for inducing employers to alter their traditional hiring practices. Without TJTC, however, there is no business rationale for maintaining those altered hiring practices and policies. Without TJTC, managers cannot justify the extra costs involved in hiring the structurally unemployed.

This insight has been proven repeatedly, and community based groups and employers alike understand their mutual needs, interests and goals related to TJTC.

This mutual understanding has taken time to develop, however, and there still remains a big job in educating a much broader range of employers, particularly small and medium sized employers, nationwide about TJTC. A permanent TJTC program would provide the basis for a massive educational effort led by the U. S. Department of Labor in collaboration with the private sector, particularly of companies such as Marriott which have used the program so successfully over time and whose credibility among other private sector employers would be a great asset in promoting the spread of TJTC.

Such excellent marketing efforts were instrumental in the mid-1980s in building exemplary summer jobs programs, especially where strong public-private partnership models had been established -- for instance, the Greater Indianapolis Progress Committee and the New York City Partnership. Such models could be useful in a renewed effort to hire disadvantaged workers in all the TJTC categories.

It is interesting that Gary Burtless, Senior Fellow at the Brookings Institution, again offered the 1982 study in Wisconsin and the 1985 study in Dayton, Ohio of the effectiveness of TJTC vouchers in persuading employers to hire disadvantaged

workers (See his March 30 testimony before the subcommittee on Select Revenue Measures). These studies are responsible for the lingering concern that presenting a TJTC voucher to an employer might actually harm the employment opportunities of a disadvantaged job seeker. When those studies were conducted, there was minimal awareness of TJTC among employers; indeed, the program was in jeopardy for lack of utilization! And indeed, a disadvantaged job applicant with limited skills and minimal work experience has little chance of obtaining work from an employer who knows almost nothing about TJTC. If that job seeker tries to educate the employer, the likelihood of failure is extremely high -- if only because of the typically poor communication skills of such applicants.

But in the decade since the Wisconsin study and the eight years since the Dayton study, awareness among employers has increased exponentially, especially among the large employers. The March 30 testimony by Thomas Hines, New York State Executive Deputy Commissioner of Labor confirms that TJTC "is a model of an initiative that worked, and worked well, in this country." New York has led the nation in utilizing TJTC.

One of the most gratifying developments in utilization of TJTC the years since the so-called "stigma" studies has been a complete turnaround in perceptions of employers. Instead of shunning these workers, hiring managers familiar with TJTC now seek out, recruit, hire and retain such workers, in part due to bonuses related to TJTC. Correspondingly, TJTC has been responsible for strong ties between the community based placement agencies, including the Job Service itself, and employers. TJTC has also been responsible for improvement of corporate images in their communities, for TJTC users now routinely receive awards and recognition as exemplary employers.

PRIORITY: EXPAND A <u>STABLE</u> TJTC PROGRAM

On behalf of the National Employment Opportunities, I urge Congress to extend the Targeted Jobs Tax Credit (TJTC) program permanently and retroactively to July 1, 1992.

In addition, we strongly recommend that Congress expand TJTC, as was done in H. R. 11 last fall, to reinstate 23 and 24 year old economically disadvantaged youth. These low-income youth were eliminated from the program in 1988 due to budgetary rather than policy reasons.

Finally, we support the further expansion of this program to include <u>all</u> economically disadvantaged veterans, as detailed in the Rangel-Johnson bill (H. R. 325) and the Boren-Packwood bill (S. 600).

We note that the Clinton Administration has recommended that TJTC be expanded to include eleventh and twelfth grade students between the ages of 16 and 20 who are enrolled in qualified apprenticeship programs and who are making satisfactory progress as determined by program administrators. The credit would equal 40 percent of up to $3,000 of first year wages, a maximum of $1,200. This category does not require youth to be economically disadvantaged. Although details of the program are still being worked out, apprenticeships would be designed to integrate academic instruction and work-based learning. <u>We believe that this well-intentioned expansion of TJTC would have an optimal chance of gaining a foothold in the business community if the core TJTC program were extended permanently</u>.

<u>Permanent</u> extension of the Targeted Jobs Tax Credit (TJTC) would provide the <u>long-term program continuity</u> essential to stabilizing the program for employer employers and community based organizations that serve members of the targeted groups.

Employers are experienced with this program: more than 5 million individuals have been placed in private sector jobs under this program since its enactment in 1978. The program has proven its worth and enjoys the enthusiastic support of employers.

Once the program is extended permanently, employers will be able to plan, establish and maintain innovative recruitment, placement and hiring practices. Community based placement agencies, including the Employment Service, will be able to use TJTC more effectively as a marketing tool in the private sector.

It will also be feasible for employers to invest in personnel and internal systems, such as corporate hiring policies and outreach programs for seeking out, hiring, and retaining structurally unemployed workers. A permanent extension will also enable many more small and medium sized employers, which create most new jobs nationwide, to learn about and utilize TJTC.

RETROACTIVE EXTENSION ESSENTIAL TO MAINTAIN EMPLOYERS' CONFIDENCE

Retroactive extension of TJTC to July 1, 1992 (the date TJTC expired) is imperative for reasons based in both policy and tax administration.

> Over 1,000 employers, representing an employee base of at least eight million, have signed a letter to President Clinton testifying that they continue to use TJTC to recruit and hire structurally unemployed workers, despite risks and costs involved. These employers have relied upon assurances from leading Members of Congress that TJTC will be renewed retroactively this year. Based on that good faith reliance, employers have incurred significant costs and have continued to implement financial and policy incentives for managers, and many employers have maintained outreach programs to recruit TJTC-eligible workers as well, expecting to recapture these costs when the program is restored retroactively.

HOW EMPLOYERS UTILIZE TJTC OUTREACH

A major example of outreach is the use of TJTC as an excellent placement tool in conjunction with the Americans with Disabilities Act (ADA) because TJTC provides assistance to employers in implementing ADA. The National Rehabilitation Association states that TJTC helps employers overcome the myths and misconceptions about persons with disabilities as workers and has helped change attitudes of employers toward the hiring of persons with disabilities. Permanent extension of TJTC can help reduce the 66 percent unemployment rate of working age persons with disabilities.

<u>A permanent TJTC program would encourage a greater and expanding use of outreach recruitment efforts</u>. The reason has become evident among large companies which have attempted to use TJTC systemically: Employers will make substantial, long-term investments in TJTC, expanding their programs to include outreach, when they know that the benefits of the program will be available over time and can be built into the organizational structure of the company. As business representatives who have testified before the Committee in past years have emphasized, outreach programs are costly. In the vast majority of cases, these programs cannot be justified without the TJTC cost offset.

On the other hand, Congress should not mandate outreach programs. First, employers will resist additional rules, regulations and paperwork. Secondly, as experienced users of TJTC have demonstrated, new TJTC practitioners require time to become acquainted with the program, to assess its utility within their unique organizational structure and in relation to their particular demands. Typically, they begin cautiously, test TJTC with a pilot program, and then develop the effort gradually. Systematic use of outreach to external organizations is a relatively advanced stage of TJTC usage, just as linkage of TJTC with other government programs, such as JTPA or Welfare Reform, must also develop gradually over time.

Exemplary users of TJTC have become increasingly sophisticated in managing TJTC. Experienced TJTC users encourage hiring managers to seek out, hire and retain TJTC-eligible workers through bonuses, inclusion of TJTC on P & L statement for a given office, store, etc.; inclusion of TJTC as part of performance evaluation of hiring managers; special recognitions and awards.

WHY EMPLOYERS ARE WILLING TO HIRE TJTC WORKERS: THE COST FACTOR

Underlying all of these points is the central rationale of TJTC -- namely, that TJTC-eligible workers are structurally unemployed. That is, they suffer disproportionately high rates of unemployment, regardless of the official unemployment rate. Workers with disabilities, for instance, suffer unemployment rates that have remained around 65-70 percent nationwide, regardless of a widely fluctuating unemployment rate in recent years. And the unemployment rate among economically disadvantaged inner city and rural youth is disproportionately high -- two to three times the national average -- no matter how strong the economy is overall.

The greatest barrier that structurally unemployed people face to employment in the private sector is their inability to fit into the mainstream workplace -- the "world of work."

Many of the individuals from economically disadvantaged groups need to learn how to dress; how to interact with the public, with supervisors, and with fellow workers; how to show up to work on time -- and consistently over time; how to maintain proper hygiene, etc. Teaching and reinforcing these basic "employability skills" through orientation, entry level training, and special supervision is costly to employers; TJTC offsets these extra costs. Employers must also cover additional hidden costs due to neglected health among these workers and their families, and initially low productivity of inexperienced workers.

Our network has told us repeatedly that a stable program would enable more employers to make a substantial commitment to using TJTC by maintaining outreach programs, hiring policies and bonus systems to maximize benefits: targeted advertising, bonuses for managers, special employee retention programs, directives to hire TJTC-eligible workers, active recruitment of the structurally unemployed.

Congress has since 1978 modified TJTC several times, increasing program efficiency while maintaining employer-friendly program characteristics, notably:

- Elimination in 1981 of an employer's ability to retroactively apply for certification of workers at the end of the year. The law now requires that all "requests for certification" be filed on or before the employee's first day of work. Since most TJTC hires start work on the day they are hired, TJTC is incorporated into the hiring decision.

- In 1986 Congress required workers to remain on the job at least 90 days or 120 hours (14 days of 20 hours for summer youth), eliminating certifications for short-term workers in industries with volatile turnover rates.

- In 1989, required employers to indicate the categories, not to exceed two, of eligibility for the TJTC applicants when employers file their "requests for certification" with the Job Service. In addition, employers must attest that a "good faith" effort was made to determine eligibility. This modification, which went into effect on January 1, 1990, eliminated practices criticized in studies of TJTC for the National Commission for Employment Policy and the GAO study.

NEON contends that the most important step that Congress could take would be to give the TJTC program a chance to work over time, proving that these modifications suffice.

STATEMENT OF THE NATIONAL HOCKEY LEAGUE BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS IN OPPOSITION TO THE PROPOSED REDUCTION OF THE DEDUCTIBLE PORTION OF THE COST OF ENTERTAINMENT EXPENSES FROM 80 PERCENT TO 50 PERCENT

Introduction:

The President's plan has the important twin objectives of reducing the deficit and stimulating growth of the economy. But the Treasury's proposal for a drastic reduction in the deductibility of meals and entertainment expenses runs contrary to those goals: It is anti-growth and anti-jobs. It severely discriminates, without justification, against the entertainment industry--which includes not only professional and college sports, but commercial and non-profit music, theater, and the other arts that contribute so much to the American quality of life. The proposal will reduce, not increase, tax revenues, and increase, not reduce, the deficit.

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The National Hockey League ("NHL") strongly opposes the Administration's proposal to reduce the deductible portion of the cost of business meals and entertainment expenses from 80 percent to 50 percent. The enactment of such legislation would:

1. Drastically reduce the revenues realized by state and local governments generated by the sports industry, such as rental payments made by sports teams to municipally-owned facilities, admission taxes, concession income, parking income and other direct and indirect payments by teams and their fans, thus requiring such local and state governments to raise taxes or further reduce services to replace the lost revenues;

2. Result in severe job losses and potential business failures in sports related industries; a high percentage of that loss will likely be concentrated in urban areas;

3. Adversely affect thousands of construction and other jobs dependent upon capital projects, such as the building of new arenas or renovation of existing facilities;

4. Result in a substantial negative impact upon revenues for NHL teams as well as other sports franchises, threatening the viability of NHL and other sports franchises in medium and small cities.

I. UNDERSTANDING THE ECONOMIC CONTRIBUTIONS OF THE PROFESSIONAL SPORTS INDUSTRY

Professional sports makes a significant contribution to income and employment in cities throughout America. The most comprehensive study on this subject was prepared in 1984 by Dr. Edward Shils of the Wharton School of Finance analyzing the economic impact of the professional sports teams on the economy of the City of Philadelphia.[1] That report concluded that for the City of Philadelphia for the 1983 year alone, the professional sports complex:

- Resulted in direct income to the City in excess of $201,000,000;

- Generated a multiplier increment of over $141,300,000 (utilizing a conservative multiplier of 1.7 for each dollar spent by fans directly);

- Accounted, as a result of the above items, for a total direct and indirect economic contribution to the City of over $343,000,000;

- Created over $15,100,000 in direct annual income to the City in the form of rental payments for arenas, parking, concessions and taxes and, the $343,000,000 aggregate economic impact produced an estimated additional $20,500,000 in tax payments to that City in the form of taxes such as wage and net profits taxes, merchantible and general business taxes and otherwise;

- Resulted in jobs for more than 3,000 local vendors supplying "sports related" goods and services.

The eagerness that cities throughout the country have shown to host sports teams confirms the results of Dr. Shils' study. Professional sports is a vital part of a local economy and any substantial reduction in the revenues and spending associated with a local team will produce a severe adverse impact.

II. THE PROPOSAL TO FURTHER REDUCE THE DEDUCTIBLE PORTION OF BUSINESS MEALS AND ENTERTAINMENT EXPENSES WILL RESULT IN A SUBSTANTIAL DECREASE IN BUSINESS SPENDING ON ENTERTAINMENT RELATED ITEMS

The underlying premise of the proposal--that it will not result in a reduction by businesses of their meals and entertainment spending--is directly contrary to the NHL's experience following the reduction of the deductible amount from 100 percent to 80 percent in the 1986 Tax Reform Act. U.S. based

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[1] "Report To The Philadelphia Professional Sports Consortium On Its Contributions To The Economy of Philadelphia", prepared by Dr. Edward B. Shils, the George W. Taylor Professor of Entrepreneurial Studies and Director of the Wharton Entrepreneurial Center at the Wharton School, University of Pennsylvania.

NHL Member Teams[2] reported on the average a noticeable drop in season ticket purchases by businesses after enactment of the 1986 Tax Reform Act, in which the deductibility of business meals and entertainment expenses was reduced by <u>only</u> twenty percent (20%).

If enacted, the 1993 proposal would have an even greater effect on season ticket purchaser for NHL U.S. Member Teams and their revenues. The current survey of the U.S. Member Teams projects an average sixteen percent (16%) decrease in <u>ticket revenues</u> if this additional reduction in deductibility is enacted. This would cost the U.S. member clubs nearly $50,000,000 per year.

The assumption that businesses will not reduce entertainment spending is wrong with respect to sporting events. With only one-half of the amount spent deductible, businesses would become more conservative in their approach to spending on meals and entertainment. A more realistic assumption is that businesses will, in fact, modify their spending behavior (as they have done in the past) and that attendance and ticket revenues will decline. And, the decrease in attendance would bring with it a decrease in spending for concessions and other "sports related businesses"--such as vendors, restaurants, hotels and transportation.

III. THIS PROPOSAL WILL CAUSE A SUBSTANTIAL LOSS OF REVENUES AND JOBS IN SPORTS RELATED INDUSTRIES

A fan attending an NHL or other professional sporting event does more than simply buy a ticket. The fan pays for transportation to the city and to and from the arena; buys food and drink before, during or after the game; parks in a municipal or other parking lot; buys game programs and novelties; and frequently stays in a local hotel overnight. Each of the industries that supplies these products or services to sports fans would be seriously damaged by the proposed legislation, as would the nearly 100 communities whose economy includes professional sports.

The magnitude of the loss to local economies can be estimated based on Dr. Shils' study and the recent survey of NHL clubs. Each of the approximately 8,400,000 fans who buys a ticket to an NHL game spends an average of $5.50 on concessions. A fall in attendance of sixteen percent (16%) would reduce gate receipts and in-arena spending on an overall basis by approximately $47,400,000. Using a conservative multiplier of 1.7[3], this overall decrease would result in over $80,000,000 in lost spending simply attributed to hockey.

When similar reductions are applied to the other major sports leagues, the decrease in revenues and spending becomes staggering. A sixteen percent (16%) reduction in attendance and a corresponding loss in spending of $5.50 per person would mean

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[2] Teams in existence in 1986 were: Boston, Buffalo, Chicago, Detroit, Hartford, Los Angeles, Minnesota, New Jersey, New York Islanders, New York Rangers, Philadelphia, Pittsburgh, St. Louis and Washington. San Jose and Tampa Bay commenced play in 1991 and 1992 respectively. Anaheim, California and South Florida will commence play in 1993-94.

[3] The 1.7 multiplier was used in the Shils report, supra.

lost gate receipts of approximately $250,000,000 from all sports and about $85,000,000 in concessions. This projects to an aggregate decrease in revenues and spending from the sports industry of $335,000,000 and becomes $569,500,000 using the 1.7 multiplier. The overall loss of spending at sporting events will adversely affect not only the sports team themselves, but also the industries dependent upon sports--the food, entertainment, hotel, transportation and other industries which are involved in supplying products and services to the professional sports industry. This translates into job losses--in addition to the ushers, ticket takers, vendors, security personnel, management and sales personnel, there are also those employed in these dependent industries as well as others who indirectly supply the products and services (hotel personnel, truckers) whose jobs may be lost as a result of curtailed sports revenues.

A majority of the employees who would lose their jobs under this proposal would be residents of urban areas who are entering their first level of employment: the worker in the meat processing plant; the man who makes the hot dogs; the parking lot attendant; the usher; the beer vendor, etc.--these are the people who will be hurt the most.

IV. THE PROPOSED REDUCTION WILL ADVERSELY AFFECT SIGNIFICANT REVENUES REALIZED BY STATE AND LOCAL GOVERNMENTS FROM THE SPORTS INDUSTRY

In addition to the loss of revenue and jobs in the private sector discussed above, the proposed reduction will have a serious negative effect on state and local municipal governments. The sports industry provides significant revenues to local governments in the form of "direct" payments such as admissions taxes, rentals for use of municipally owned arenas and other taxes, as well as "indirect" payments that result from activities associated with the sporting event--taxes on novelties, concessions, entertainment and the like. For example, the Shils report estimated that in 1983 the sports industry produced over $15,100,000 in direct payments to the City of Philadelphia and an additional $20,500,000 in taxes from sports related industries for an aggregate contribution to municipal revenues of $35,600,000. During the 1991-92 season NHL U.S. Member Clubs alone made more than $25,000,000 in payments, not including state and local income taxes, to state and local municipal governments for sales tax, ticket surcharges, property taxes and rental payments. The aggregate payments by all sports teams is doubtless at least four times that amount. These revenues are critical to the municipalities that receive them.

Thus, the inexorable impact of the proposal and its corresponding decrease in attendance and related spending will be to reduce payments from sports teams to state and local governments. A reduction in sports-related spending will also limit the ability of municipalities to meet previous capital commitments. For example, nine of the sixteen NHL U.S. teams currently rent municipally-owned arenas and pay rent to municipalities based in part upon revenue from ticket sales. Significant reductions in ticket sales revenue--and corresponding reduction in rental payments will severely diminish the ability of many municipalities to pay for those facilities. The municipalities will suffer additional losses in sales and other taxes that will occur from the corresponding decrease in spending: at restaurants; on parking; novelties; and on concessions.

The ultimate result will be an increase in local property and sales taxes to compensate for the loss of rent and taxes payable by the sports teams. Such a scenario would be an ironic unanticipated consequence of the tax proposal: the cost of reducing the deductibility of business meal and entertainment expenses will be billed to the so-called "ordinary taxpayer" who may not be attending a sporting event or utilizing the sporting arena at all.

V. THE PROPOSAL WILL ADVERSELY AFFECT SIGNIFICANT PUBLIC WORKS PROJECTS

A further consequence of this proposal will be to discourage major sports-related public works projects and threaten the new jobs that are typically created by such projects.

In the NHL alone there are at least 10 new U.S. hockey arenas in the proposal or construction stage (others in the planning stage) that are ultimately dependent upon the economic health of sports franchises. When considering the other professional sports, the number of planned construction projects is likely significantly more. The feasibility of these projects is based upon a minimum level of rentals, admission taxes, sales taxes and other revenues produced by the teams. It is possible that many of these proposed arenas may not reach the construction phase if this legislation passes. Loss of these proposed arena projects, the cornerstones of urban revitalization, will severely hamper the Administration's goal of rebuilding our cities.

The economic importance of an arena project to a municipality is apparent from the example of one NHL Team, located in a smaller geographic market, that is contemplating a new arena. The economic impact study prepared by Ernst & Young Valuation Services in connection with that planned new arena concluded that:

- the total economic output associated with the project to the city would grow from approximately $36,400,000 preceding construction to $81,600,000 in the post construction phase, with a high of $124,100,000 during the construction phase;

- there would be an increase in employment (direct and indirect) from an average annual level of 350 jobs pre-construction to an average of 469 jobs post-construction, with a high of 1010 jobs during construction;

- the state and local municipalities would realize increased tax revenues from an estimated $5,300,000 annually pre-construction to an estimated $11,300,000 annually post-construction, with $12,100,000 annually during the peak construction phase.

It is clear from this analysis that these projects are a significant source of increased jobs and revenues to the private and public sector. It may be, however, that few, if any, new sports facilities will be constructed if the proposal is enacted. As you may be aware, financing for arena projects, both public and private, is dependent on projected revenue streams from the arena. The proposal's adverse impact on team and facility revenue will imperil and, indeed, in some cases eliminate the

business financing of multi-million dollar investment projects which would otherwise contribute substantially to the economies and vitality of cities throughout the country.

Thus, whereas the Administration's economic objectives are to stimulate growth and job creation, the proposal, in fact, has the unintended effect of eliminating a great number of jobs, threatening major projects which are a primary focus of their communities and are keys to the future growth of the cities whose vitality is of major importance to the economy.

VI. UNINTENDED IMPACT ON SMALL BUSINESS

A. The stated underlying rationale for the proposal is that the reduction in the deductible percentage "will reduce the amount of personal expense inherent in these expenditures that are deducted for tax purposes." This rationale fails, however, when it is applied to the situation of the small business persons and entrepreneurs.

Several years ago a member club of the NHL in a small market conducted a demographic survey of its business season ticket holders. That survey found that 66% of those businesses surveyed were either individually owned or small businesses with less than 250 employees. In fact, it is the NHL's experience that the typical business season ticket holder or business purchaser of individual game tickets is the small business person. The tickets purchased by small businesses are generally used for customers, suppliers, employees, and as a marketing tool to enhance relationships with present customers and clients and, more importantly, to develop new ones.

The entertainment of current and prospective customers, suppliers, and clients at sporting events is one of the few ways in which the small business can compete with its large corporate competitors. Small businesses cannot, for example, afford to underwrite extensive advertising campaigns involving multi-media exposure or to attend seminars and trade shows at resort locations. Such advertising and promotion opportunities, which remain totally deductible, are reserved for large entities with vast resources. A sporting event provides the small business person with a perfect setting to "compete" on an equal footing with big business by providing the business person with three to four hours of close contact with the customer, client, or supplier. Unlike the typical business lunch or seminar, attending a sporting event provides the small business with a unique format for conducting business and the data from our Member teams indicates that it is the small businesses that take advantage of this opportunity.

In this difficult and extremely competitive economy, small businesses must be highly sensitive to changes in their expenses, and would be most disadvantaged by the Treasury's proposal. Thus, the Administration's proposal would have the unintended effect of reducing the competitiveness and undermining the growth of small businesses.

VII. UNINTENDED EFFECT - INCREASED TICKET PRICES AND LOCAL TAXES

Another damaging consequence of the proposal will be on the "ordinary fan" attending games. Most significant expenses for a team are fixed--rent, operation, salaries--and, in the sports industry today, the only possible way to recoup lost revenues resulting from the proposed reduction would be through ticket price increases. In order to cover the projected per team loss of revenues in the NHL, the average U.S. ticket price would have to go from $24.75 to $29.25 ($58.50 for a pair) and $2,457.00 for a pair of season tickets--a price beyond the means of a majority of "ordinary fans" (who may be small businessmen) whom the proposal would purportedly benefit. For sports teams it is season ticket revenues, more than individual game day purchases, that are the lifeblood of the sports industry. Marginal franchises and those in small cities could not stand such a price increase and would have to move or die.

VIII. THE CONSEQUENCES OF THE PROPOSAL'S EFFECT OF REDUCED REVENUES TO SPORTS TEAMS AND NHL TEAMS IN PARTICULAR

We have seen the economic benefits to localities produced by sports teams and sporting events and the significant adverse effects that result if spending related to the sports industry is caused to be reduced. The adverse affects resulting from enactment of the proposal are distinct possibilities--not cries of wolf--especially when viewed from the perspective of the sports industry itself and hockey in particular.

The estimated decrease in gate receipts will likely have serious implications to many NHL teams. Member clubs of the NHL are extremely dependent upon gate receipts--more so than any other major professional sport--and a large percentage of each Member Team's gate receipt is directly tied to support from the local business community. On an average, at least sixty percent (60%) of a team's revenues are from gate receipts. Unlike the other major sports, the NHL cannot rely on revenues from television to support its Teams. In 1991-92 the average share of national television revenue for each of the NHL teams amounted to less than $1,500,000 or less than 7.3% of the average total revenues and the figures for 1992-93 will not be substantially different. The projected reduction in gate revenues may in some instances, bring into question the economic viability of certain NHL teams. Thus, the proposed reduction does have serious and real consequences to professional sports. It also will produce economic injury to the related industries and employees which depend on sports for their survival and will place an increased burden on the ordinary fan and ordinary taxpayer in the form of higher ticket costs and additional taxes to support municipally financed sports facilities.

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This is at least the fourth time in recent years federal legislation has sought to punish the sports and entertainment industry under the guise of "fairness". Our ability to amortize the cost of player contracts has been sharply restricted; the deductibility of the premium price paid for luxury boxes has been substantially eliminated; the deductibility

of tickets and related sports and entertainment expenditures has already been reduced by 20 percent. A further reduction by another 30 points--for an industry that contributes so much to the economy and the morale of the American people--is totally unwarranted. Abuses are adequately dealt with under the existing statute, regulations and rulings. The further onslaught on the sports and entertainment industries as proposed would itself be unfair and would produce only lost revenues, lost tax revenue and lost jobs. We urge that needed tax proceeds be generated--as they can be--by measures applied across the board in all industries, without discrimination and without needless harm to an important segment of the economy.

Respectfully submitted,

NATIONAL HOCKEY LEAGUE

TESTIMONY OF DANIEL D. PEARLMAN
National Housing Law Project

I. INTRODUCTION

The National Housing Law Project is submitting this statement recommending permanent extension of the Low Income Housing Tax Credit (LIHTC) with certain critical amendments. The following changes are necessary, at this time, to ensure that applicants and tenants are treated fairly, that poverty-level households receive a "fair share" of the units at affordable rents and that the housing produced under this Program be available to the targeted households for as long as economically feasible.

The National Housing Law Project was established in 1968 to serve as a resource on housing issues for attorneys representing low-income people nationwide. We are funded primarily by the federal Legal Services Corporation and also by various foundations and California's Interest on Lawyers' Trust Accounts Program. Our primary responsibility is to work closely with the lawyers in over 300 different Legal Services programs around the country who on a daily basis represent poor people with problems related to housing and community development. During the 15 years, we have taken on three major additional projects. The first was our Multifamily Demonstration Program designed to analyze the management and financial difficulties which HUD-subsidized, privately-owned projects had begun to encounter in the mid-1970s. The second was to provide legal representation to nonprofit housing sponsors who were considering whether to syndicate their projects. The third is to assist nonprofits, residents and others in preserving the expiring-use projects. Finally, from time to time, we undertake special research projects in the housing and community development area with funding from foundations and other sources. In the past ten years, those projects, for example, have included research and publications on the problem of displacement and how to reduce it, the preservation of single-room occupancy residential hotels, legal restraints upon public housing authorities' tenant selection decisions and the rights of poor people to combat racial discrimination in the housing.

The recommendations presented in this statement are derived primarily from the experience which we have gained over the last 20 years in carrying out the activities described above and our work on tax credits and syndications. We contributed to the development of the LIHTC in 1986. Our paper on the "State Administration of the Low Income Housing Tax Credit" contributed to several amendments to the LIHTC. We also participated in the drafting of California's low-income tax credit, held national conferences on syndicating affordable housing and provided advice to dozens of nonprofits in their negotiations with syndicators.

II. OVERVIEW

The LIHTC is estimated to produce 100,000 units of housing per year with 20-25 percent being developed by nonprofits. It is the largest source of federal assistance for the development of low-income housing. The LIHTC should be extended with certain critical amendments to address three major principles. First, housing developed with indirect expenditures should provide the same fairness protections that are mandated for beneficiaries of programs funded with direct federal expenditures. There is no rational reason why housing developed through indirect expenditures should not have the basic tenant protections provided by the HOME Program and Section 221(d)(3) and Section 236 housing such as good cause eviction, anti-discrimination against Section 8 holders, relocation assistance and fair housing protections.

Second, poverty-level households should receive a fair share of the units developed under the LIHTC. The current economic incentives and targeting provisions only result in poverty-level households only living in tax credit units when Section 8 is available or when state and local governments succeed in leveraging other limited resources.

Third, housing developed with significant federal subsidies should be available for the targeted population for as long as economically feasible. To do otherwise will result in much of the housing being lost to low-income households after 15 years or Congress being faced with a replay of the Section 221(d)(3) and Section 236 housing crisis. While Congress is to be commended for enacting legislation to preserve the Section 221(d)(3) and Section 236 housing units, the tragedy is that we will be paying an estimated $18 billion for the appreciated value of these buildings when the developers had little expectation of an increase in property value. Similarly, almost all tax-credit investors are simply purchasing tax credits and passive losses. The investors' payments do not reflect any possible appreciation.

III. RECOMMENDED AMENDMENTS TO LIHTC

A. TAX CREDIT CHANGES

1. Prohibition of Discrimination Against Subsidy Holders

Poverty-level households, those with incomes below 35 percent of the area median, cannot afford to rent units in tax-credit projects without a deep rental subsidy. The numbers in many markets simply do not work. Often those who are fortunate enough to have such subsidies are refused units in tax-credit projects. Every other federal housing construction program, including the new

HOME program, carries with it a prohibition on discrimination against certificate and voucher holders.

2. Relocation Assistance

We have received reports from Legal Services attorneys of tenants being displaced by housing projects receiving the tax credit. Displacement can be caused when a building is acquired and razed for new construction or when major rehabilitation work is needed. We believe that tenants who lose their homes as a result of LIHTC should be provided with protections comparable to those offered under the federal Uniform Relocation Assistance (URA).

The URA requires any of 17 federal agencies or private developers who displace with federal funds to provide moving expenses and three and a half years of rental housing assistance to those permanently displaced. The funds to enable displaced families to afford other rental housing would be provided by the developer from the various resources available to the developer. In some cases, Section 8 Rental Assistance could be used. We do not know how often this displacement happens. We do know that developers who also use CDBG funds are obligated to meet the stricter anti-displacement provisions of that law. HOME funds also carry a URA obligation. Alternatively, states should be directed to ensure that these benefits are provided through comparable state or local provisions.

3. Good Cause Eviction Requirements

Every federal housing program, including HOME, supported by a direct expenditure of federal funds carries with it a simple good cause eviction requirement. This protection is essential for tenants who in most cases do not have lawyers to represent them as landlords do. Good cause includes serious or repeated violations of the terms and conditions of the lease; or violation of applicable federal, state or local law. This is a minimum requirement to which owners of tax-credit projects should have no reason to object. The language from the HOME statute should be used in amending the LIHTC.

4. Long-Term Use Restrictions

Congress spent the last several years devising a complex and some might say costly solution to the prepayment issue. To avoid a repeat of this performace, the tax-credit legislation should be amended to require owners to maintain the tax-credit units for the targeted income groups for the greater of 50 years or the meaningful useful life of the building, provided it is economically feasible. Furthermore, the owner should be required to dedicate any profits from the ultimate sale of the building to support the

development or acquisition of low-income housing units. The issue of longer term affordability requirements was raised in previous years and Congress enacted the "extended low-income use provisions" and amended the "qualified allocation plan" provisions to require states to issue selection criteria which include preferences for projects serving qualified tenants for the longest periods in 1989 and 1990 respectively. These amendments, which improved the original legislation, are not adequate to preserve most of the housing.

The extended low-income use amendment simply requires owners who want to change the use before 30 years have elapsed to offer the property for sale to housing credit agencies at a fairly steep price. It does not assure long-term affordability for two reasons. First, owners can wait until year 30 and convert the housing to a higher and better use. Second, if there are no purchasers at the statutory price, the owner can evict the low-income tenants after year 18.

A recent review of state allocation plans by the National Housing Law project shows that approximately one-third of the states have developed allocation plans that should encourage tax credit developers to commit to longer-use provisions when there is competition for the tax credit. While the remaining two-thirds of the states might improve their allocation plans, the preservation of these projects for as long as possible should be required by Congress as opposed to leaving it to the state agencies and developers within a state.

Congress was reluctant previously to adopt longer-term use restrictions because of the fear that developers would not seek the tax credit and investors would not invest if projects were not offering appreciation. Recent California experience demonstrates otherwise. Over the last two years, the California Tax Credit Allocation Committee has awarded approximately $73 million in state and federal tax credit to 166 developers supporting 9,120 units of tax-credit-assisted units. All but five of the developers have committed to maintaining the low-income use for at least 55 years. All of the 109 developers who received just the federal tax credit are legally bound to 55-year use restrictions. In fact, many of these transactions anticipate that the units will be available to the targeted population in perpetuity. No developer has returned the credit allocation because of an inability to find investors. Furthermore, these provisions have not had a significant, if any, impact on the total amount of equity raised for a project. In addition, Massachusetts and Rhode Island have adopted minimum compliance of 30 years for their tax-credit-assisted developments.

Some people have questioned longer-term use restrictions on the grounds of disinvestment and the fear that future financial feasibility problems will lead to foreclosure or force tax credit owners to become slumlords.

While potential disinvestment is a concern, shorter-use restrictions do not guarantee that the properties will be maintained. In fact, many owners have previously failed to maintain rental properties when there were no use restrictions. More significantly, the loss of the low-income units is not the solution to potential disinvestment problems.

The concern over future financial feasibility is one we share and can be resolved by the method Congress adopted in the Resolution Trust Corporation (RTC) statute or the State of California enacted as part of the state's tax credit program. Thus, the amendment, requiring owners to maintain the property for low-income use for the greater of 50 years or the properties' remaining useful life, should recognize that the owner might have financial feasibility problems after 15 years. Congress addressed this issue in the RTC legislation by permitting the Corporation to temporarily reduce its lower-income occupancy requirements if it determines that an owner's compliance with such requirements is no longer financially feasbile. The owner is required to make a good-faith effort to return lower-income occupancy to the required level and the Corporation reviews the reduction annually to determine whether financial infeasibility continues to exist.

California's state tax credit program, which imposes a 30-year minimum use restriction, contains a financial feasibility concept similar to the RTC legislation. It permits the temporary removal of low-income units, when necessary, to maintain economic feasibility which is defined as project revenue equalling or exceeding project operating expenses, excluding any cash return on investment. Operating expenses are defined as those necessary to cover reasonable operating expenses and to maintain a building in habitable condition, including debt service, taxes and reasonable reserves.

The amendment should also permit owners to sell their property as long as the buyer purchases the development subject to the original use restrictions.

We urge Congress to enact permanent long-term use restrictions and to eliminate the specter of a second generation of "expiring use projects" displacing tenants of tax-credit projects and/or placing demand on Congress for tremendous sums of money to save this treasured resource of housing for low- and very low-income families.

5. Improved Targeting

The statute requires that at least 20 percent of the units be occupied by households at 50 percent or less of area median income or 40 percent at 60 percent or less of median income. Rents on these units cannot exceed 30 percent of the designated area median income level. In some markets tax-credit projects exceed this minimum requirement. We do not know what percentage of tenants are at the top of these ranges and how much below the rest are. We are, however, confident that very few tax credit developments are serving significant numbers of poverty-level households. The 1989 Amendments require states to give preference in the allocation credits to projects serving the lowest-income tenants. A recent review of state allocation plans by the National Housing Law project shows that approximately one-third of the states give sufficient weight to this preference in their allocation plans for the preference to have substantial impact when developers are competing for the credit. While some states might improve their allocation plans and data, if obtained, on who are living in the developments might be better than our study suggests, the following amendments are essential if poverty-level households are to receive a fair share of the tax-credit units.

Ideally, the legislation should be amended to require that at least one-third of the assisted units be set aside for households earning less than 35 percent of area median income (those at the poverty level) at rents that are no greater than 30 percent of a household's actual income provided Congress appropriates funds for project-based Section 8 subsidies specifically set aside for tax-credit projects. The August 1990 GAO study also recommended additional subsidies.

The statute should also be amended to require all states to amend their tax-credit allocation plans to give the highest priority to projects serving the greatest number of households identified by the needs section of the applicable state or local Comprehensive Housing Affordability Strategy as having the greatest need for housing even if project-based subsidies are not available.

The fundamental question for Congress is whether tax-credit projects should primarily serve families earning $20,000 to $30,000, or also be available to a wide range of very low-income families, including poverty-level households. In 1992, a family of four earning less than $13,950, was below the poverty line. To illustrate the problem, the 1991 household income and rents for tax-credit projects, whose owners committed to serve families at 60 percent or less of area median income, were set as follows in the cities indicated:

City	Maximum Median Income for Household of Four	Maximum Rent for 2 Bdrms.	& 3 Bdrms.
Atlanta	$26,460	$595	$688
Birmingham	19,140	431	498
Boston	30,420	684	791
Detroit	26,760	602	696
Los Angeles	26,100	587	679

The gross pay of a one-parent low-income household earning $4.50 per hour is $720 per month. A household with two members earning $4.50 per hour would have a gross monthly pay of $1,440. Tax-credit projects are simply beyond the reach of many poor and many working poor households.

6. <u>HOME-Related Changes</u>

The statute should be amended to make HOME funds eligible for the 70 percent of present value credit. This change would significantly increase the amount of equity available to support tax-credit projects and make it easier for developers to serve households with the greatest housing need.

7. <u>Rights of First Refusal</u>

In 1990, Congress amended the Internal Revenue Code to allow low-income housing tax-credit syndications to provide certain organizations with a "right of first refusal" to purchase the housing at a below-market price at the end of the tax credit period. The minimum price is the project's debt plus the investors' exit taxes. Unfortunately, the cost of the latter obligation is likely to be prohibitive for many community groups. Exit taxes for a single 38-unit project entering construction in New York City last year are estimated at $568,000.

It would greatly benefit low-income families if Section 42(i)(7) of the Internal Revenue Code were amended to authorize a right of first refusal that enables approved organizations to purchase merely by assuming the project's debt, without having to pay investors' exit taxes. Since the right of first refusal is not mandatory, but only an option available to partners in low-income housing tax-credit syndications, such an amendment would not deter investment. It would, however, make an enormous difference in the ability of the statutorily-approved organizations to gain ultimate ownership of the housing.

8. <u>Fair Housing Requirements</u>

As with all other federally assisted housing programs, there is a need for affirmative fair housing requirements in the tax-credit legislation. Since many of the statutes, regulations and Executive Orders affecting fair housing refer to HUD specifically, the tax-credit legislation should make clear that the same requirements apply to this housing program under the jurisdiction of the Treasury Department.

We suggest the following provisions be added to the Low Income Housing Tax Credit legislation:

a. <u>Certification</u>

Each recipient should certify that the tax credits are used and the developments administered in conformity with Title VI of the Civil Rights Act of 1964 and the Fair Housing Act, Title VIII of the Civil Rights Act of 1968, and that the recipient will affirmatively further fair housing.

b. <u>Affirmative Marketing</u>

Each recipient should adopt and carry out an affirmative marketing program to attract buyers or tenants, regardless of sex, of all minority and majority groups to the housing for initial sale or rental, in accordance with the provisions of HUD's affirmative fair housing marketing regulations, 24 C.F.R. §§ 200.600 <u>et seq.</u>

c. <u>Nondiscrimination and Equal Opportunity in General</u>

The tax-credit program should also be administered in conformity with HUD's regulations governing nondiscrimination and equal opportunity in housing under Executive Order 11063.

d. <u>Reports</u>

In order to ensure that these units are fairly distributed, the Secretary of the Treasury should make a report at least annually on the racial, ethnic, gender and income characteristics of the residents of the units. HUD and FmHA are presently required to so report.

B. <u>TAX-EXEMPT BOND FINANCING</u>

The first three and the last provision under (A) should also apply to rental housing financed by tax-exempt bonds for reasons described therein.

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JOINT STATEMENT OF THE
NATIONAL LEASED HOUSING ASSOCIATION
AND THE
COALITION TO PRESERVE THE LOW INCOME HOUSING
TAX CREDIT

BEFORE THE COMMITTEE ON WAYS AND MEANS

MARCH 23, 1993

CONCERNING THE EXTENSION OF THE LOW-INCOME HOUSING TAX CREDIT

Mr. Chairman and Members of the Committee. Thank you for this opportunity to submit this statement for the record in conjunction with your hearings on President Clinton's economic proposals. This statement concerns the President's proposal to extend permanently the low income housing tax credit.

This statement is submitted jointly by the National Leased Housing Association and the Coalition to Preserve the Low Income Housing Tax Credit. The National Leased Housing Association is a unique organization that services virtually all participants in the multifamily housing field. NLHA's over 600 members include non-profit and for-profit developers, owners, managers, public housing authorities, state housing finance agencies, local governments, equity financiers and professionals experienced in this industry. The Coalition to Preserve the Low Income Housing Tax Credit is an organization comprised of non-profit and for-profit equity financiers, developers and others who are involved in the provision of affordable housing to low-income Americans and who have utilized the low-income housing tax credit in order to raise equity capital for such projects.

THE CREDIT MUST BE EXTENDED ON A PERMANENT BASIS

Mr. Chairman, we begin by thanking you for your outstanding leadership and continuing support for this program and particularly for your early introduction of H.R. 18. We recognize and commend your deep commitment to this tax credit. We are also grateful to the President for his support for permanent extension.

1993 will be the fifth year in which the low-income housing community has urged the Congress to put this very valuable and successful program on a permanent basis. We know that you have heard our pleas in prior years for permanent extension and that the Committee agrees with the need to provide long term certainly to those involved in the provision of this housing. We recall with gratitude that in 1992, under the Chairman's leadership, the Committee and the Congress passed permanent extension legislation, only to see it eventually derailed due to President Bush's vetoes of tax legislation.

We were pleased to note that each witness appearing before the Committee has urged that this program be permanently extended. The groups from whom you have heard represent virtually all sectors of the housing community from tenants, credit allocation agencies, housing advocates, builders, realtors, non-profit and for-profit developers and equity financiers.

Support for this program extends beyond those of us in the housing community. You have heard from State and local governments about the importance and success of the tax credit. The press has been overwhelmingly supportive: editorials urging extension of the program have appeared in dozens of newspapers around the country, including the Chicago Tribune, Chicago Sun Times, New York Times, Washington Post, San Francisco Examiner, Boston Globe, Pittsburgh Post Gazette, Christian Science Monitor, Crain's Business and the Toledo Blade. At least fifty national

organizations have written to the Congress on a number of occasions over the past several years asking that the program be made permanent.

Recently, more than 800 community-based housing organizations wrote to Chairman Rostenkowski and others urging permanent extension of the tax credit. This program has become the linchpin for these organizations in their efforts to produce housing for low-income Americans.

If the Congress is to maintain its decades-long commitment to housing for low-income Americans, the tax credit, which plays an integral part in the provision of that housing, must be extended permanently. The tax code has for over 20 years recognized that low-income housing deserves special treatment; the low-income housing credit has maintained that recognition in a most effective manner.

Mr. Chairman, as you have so aptly noted in the past, short-term extensions do not permit the housing community the necessary time to plan these risky and increasingly complicated developments. The process of developing low-income housing is a multi-year undertaking. Unless those involved in developing this housing have confidence that the credit will exist in coming years, they will be unwilling to invest the money, time and commitment it requires in putting together this housing. The result is that less housing is built; less poor people are housed; less employment is created.

It is not just the development sector of this industry that needs time to plan this housing. Mortgage lenders, equity financiers and state credit allocating agencies must also devote substantial resources to hiring and training staff and developing programs and procedures to implement and administer this program. Many such entities are unwilling or reluctant to make these investments when the fate of the program is so uncertain.

As we discuss below, lack of available mortgage financing has been one of the greatest problems we confront in this industry; it is very difficult to persuade already reluctant lenders to develop the necessary mortgage financing products when the program may disappear in a matter of months.

Lack of permanence also sends the wrong signal to potential investors, who are concerned that Congress will retroactively deny their benefits in the manner that occurred after the adoption of the passive loss rules in the Tax Reform Act of 1986. Although we do our best to reassure them that support for this program in the Congress is strong, a good deal of equity capital that could be invested in low-income housing is lost because of these concerns. However, a permanent extension would signify strong and lasting Congressional support, would allay investor concerns and would, we are certain, result in more capital being raised for this housing.

PERMANENT EXTENSION OF THE TAX CREDIT WILL PRODUCE JOBS AND PROVIDE A STRONG ECONOMIC STIMULUS

Mr. Chairman, we recognize that the Congress and Administration are faced with some very difficult decisions in the coming months. One thing should be very clear: permanently extending the low income housing tax credit will provide ongoing employment for thousands of American workers; it will produce federal, state and local income tax revenues on the wages earned as a result and it will help solidify often shrinking real estate tax bases for State and local jurisdictions struggling to finance schools, public safety, health programs and dozens of other critical services.

According to the National Council of State Housing Agencies, the tax credit was responsible for the creation of 52,000 jobs during 1992. These are jobs for the construction trades, building

supply manufacturing and distribution industries, property management firms, maintenance personnel, financial services companies and among real estate professionals. The are jobs in the districts of virtually every member of Congress.

In very simple terms, extending this program means jobs; eliminating it means more unemployment. Spending money here saves substantial expenditures for the unemployment insurance fund, a program with which we know the Committee has struggled.

There is one area of employment that, we are pleased to note, will not increase if the low-income housing tax credit is extended: the Federal bureaucracy. This is a program which has been effectively administered by a small and dedicated staff at the Treasury Department and Internal Revenue Service. As the Committee knows, the vast bulk of the administrative functions are handled at the State level and that will not change if the program is extended. The Committee should take pride that the tax credit has been efficiently handled without resort to an expensive Federal bureaucracy.

RESULTS TO DATE UNDER THE PROGRAM JUSTIFY PERMANENT EXTENSION

Mr. Chairman, there can be no doubt that the credit program has been a spectacular success and has fulfilled and perhaps surpassed Congressional objectives. No small part of this success has been the spirit of cooperation the program has fostered between the private and public sectors, particularly with the state housing credit agencies which have done such a fine job of allocating and administering the credit. Moreover, the credit program has served as a catalyst for the development of a vibrant and effective non-profit development community and their active participation in this industry has strengthened our ability to deal with the affordable housing crisis facing the Nation.

Despite the fact that the program started slowly, from 1987 through 1992 this program has produced or will produce over 500,000 units of low-income housing, according to figures compiled by the National Council of State Housing Agencies. Ninety-four percent of the multifamily housing units which have rented for less than $450 per month (making it affordable for families with incomes of $18,000 or less) have been assisted with the credit. As our colleagues from the Council on Rural Housing and Development point out in their testimony, without the credit, the Farmers Home Administration Section 515 program would cease to function, depriving hundreds of thousands in rural areas a chance for decent housing.

The credit program is responding to a desperate need as a number of recent studies have dramatically demonstrated. One study, by the Economic Policy Institute showed that among renter households with four or more persons whose incomes are between $10,000 and $30,000, there is a "shelter poverty incidence" of 80 percent. (Shelter poverty measures housing affordability on a sliding scale with maximum affordability percentages varying with income and household characteristics.) Among all renter households, more than 40 percent are shelter poor and nearly 50 percent pay more than 30 percent of their income toward rent, the more traditional method of determining housing affordability.

MODEST CHANGES TO THE PROGRAM MAY BE NECESSARY TO ASSURE CONTINUED SUCCESS

In 1989 and 1990 the Congress, following this Committee's leadership, made a number of worthwhile changes to the credit program, designed to assure that scarce federal resources were being wisely and efficiently spent. Coalition President and NLHA Board Member John P. Manning participated in the Mitchell-Danforth Task Force, which recommended a number of the amendments which were eventually enacted.

With that background in mind, we propose several additional changes which we believe are necessary if this program is to continue to fulfill Congressional expectations. Many of these recommendations have been contained in prior legislation passed by this Committee and the Congress.

Need for Debt Financing

As the Committee is well aware, despite recent drops in interest rates, there continues to be a "credit crunch" throughout the country. Nowhere is it felt as severely as in the low-income housing sector. Developers, both non-profit and for-profit, unanimously agree that finding mortgage financing has become the single greatest impediment to the development of affordable housing. Savings and Loans and commercial banks are reluctant to lend on any real estate; loaning for low-income housing is virtually unthinkable (with the exception of the Federal Home Loan Banks' Affordable Housing Program, which can meet only a fraction of the overall need). With the demise of the FHA coinsurance program and the implementation of new restrictions by HUD on tax credit properties, FHA-insured financing has ceased to address the need. Indeed, the decrease in the credit actually allocated by the states during 1990 and 1991 is, at least in part, attributable to the difficulty in finding mortgage financing, although other factors played a role as well.

The Congress could help address this situation by allowing the use of the 70 percent credit with financing provided by tax-exempt bond proceeds and with financing under the HOME program, enacted as part of the Cranston-Gonzalez National Affordable Housing Act of 1990. Under present law, the use of tax-exempt bonds restricts a project to the 30 percent credit and has resulted in very little utilization of such bonds in credit eligible projects because, quite simply, the "numbers" do not work. If this restriction were removed or modified, bond financed credit projects would become feasible and such financing could begin to fill a very critical need for mortgage debt.

With respect to the HOME program, federal funds are being provided, largely by formula in a block grant approach, to State and local governments for use under statutory and regulatory guidelines. This program in many respects resembles the Community Development Block Grant ("CDBG") program. The Committee will recall that in 1989, the Congress amended the Code to provide that CDBG funds could be utilized in conjunction with the 70 percent credit. The Code should provide that HOME funds can also be used with the 70 percent credit.

Need for Additional Sources of Equity Capital

There are certain restrictions now in the Code which hinder the raising of equity financing for tax credit eligible properties. If left unchanged, these provisions could jeopardize our future ability to raise sufficient capital to finance all the housing that will receive the credit. Of course, the enactment of a permanent extension would have a very positive impact on our ability to raise funds. However, we believe that the Congress could further help the situation in two important ways.

First, the Congress should pass legislation which would modify the passive loss rules to allow the use of approximately $20,000 in low-income and rehabilitation credits against taxes on non-passive income. A number of investors have told equity syndicators that they would welcome the opportunity to invest more capital in credit projects but for the limit of approximately $7,000 in credit against taxes on non-passive income. Furthermore, other higher income individuals have said that a $7,000 credit is just not worth the time and energy it takes to understand the investment.

Most in the equity capital industry are finding it increasingly difficult to locate investors interested in this program. The present limit makes it impossible to attract many individuals who have already invested and it discourages other higher income investors. Raising the limit to approximately $20,000 would free up this badly needed capital and would help assure a steady flow of equity to credit eligible projects in coming years.

However, raising the limit alone is not sufficient. Even more importantly, the Code should be amended to permit the credit to be used against the Alternative Minimum Tax.

The nationally recognized certified public accounting firm, Reznick Fedder & Silverman, has completed the analysis attached as Exhibit A concerning the impact on Low-Income Housing Tax Credit investment of the current Alternative Minimum Tax ("AMT") as well as the revised AMT proposed by the Clinton Administration.

The analysis demonstrates that, except for very wealthy taxpayers, due to current or proposed AMT restrictions, virtually no investors are able to fully utilize $7,000 in Low-Income Housing Credits which would otherwise be available under the special exception to the passive loss rules for such Credits. (Code Section 469(i) allows a $25,000 deduction equivalent against income from any source for Low Income Housing and Rehabilitation Credits, which equates to $7,750 in Credits at the 31% bracket and $7,000 at the 28% bracket.) As the Summary Analysis demonstrates, under present law, because of AMT limits, taxpayers are unable to utilize currently as much as $4,509 of the $7,000 they would have had otherwise available. Similarly, under the proposed rates, up to $4,109 could not be taken.

The analysis is based on hypothetical taxpayers and makes certain assumptions as to income and deduction amounts. While the hypothetical will not, of course, be applicable to all taxpayers, we believe that it represents a fairly typical case and that almost all taxpayers will be severely limited in the amount of Credits that can be utilized because of the AMT.

This situation creates at least three problems. First, by limiting the amount of Tax Credits which individuals can utilize, the amount of capital which new investors will contribute is greatly reduced. The result is that less equity is available for projects being developed and less units are produced. Second, those who have already invested once and who may be very pleased with their decision are unlikely to invest additional funds because of the AMT. Third, existing investors, who believed that Congress would not again retroactively deny their benefits, have seen their Tax Credit utilization substantially eroded since the AMT rate was increased in 1990. It is not only unfair to penalize investors in this manner, but word of their frustration makes it even more difficult to raise capital from other investors. Attached as Exhibit B is a letter received by an equity syndicator from a disgruntled investor concerned about this problem. His letter eloquently states the unfairness which results from the AMT.

We are proposing that a limited amount of Low-Income Housing and Historic Rehabilitation Credits be usable against the Alternative Minimum Tax. Specifically, we suggest that individuals be allowed to use these Credits to reduce AMT liability by up to 25 percent, to a maximum of $20,000.

Another commonly expressed concern which has limited the ability to raise capital is that the return to investors in the early years of an investment is much less than the return that is otherwise expected. The rate of return in the first year of an investment may be as low as two to three percent, much less than one could expect to receive from a federally-insured savings account.

The reason for this phenomenon is that the first year credit is reduced by a special averaging convention contained in Section 42(f), which requires the credit to be determined by occupancy levels at the end of each month during the first year, when the project is likely to be renting up for the first time. Furthermore, many owners must wait until the year after the project is placed in service to begin claiming the credit since claiming the credit before the project is fully rented results in much lower credit being generated than would otherwise be possible.

In order to rectify these problems, we would suggest that the owner be provided with an election to claim a tentative credit (not to exceed the amount allocated by the credit agency) for the first year that the building is placed in service, commencing from the month the building is placed in service without diminution by the first year averaging convention. The tentative credit would then be redetermined not later than the close of the first full year after placement in service by determining the qualified basis at that point. If the finally determined credit were less than the tentative credit, the difference would be recaptured immediately. All other rules of the program, except perhaps for some technical and conforming changes, would not need to be altered.

Need to Modify Rent Rules

In 1989 the Congress changed the manner by which rents were determined by requiring that rents be figured on the basis of the number of bedrooms in a unit, not by the number of occupants. This change was fairer for both tenants and owners and provided predictability when underwriting tax credit projects. However, the change was made only for projects receiving allocations in 1990 and thereafter.

A persistent problem for owners and managers of these projects is the confusion caused by the different rent rules which apply for projects depending on when they received an allocation. These new rules, which Congress determined to be more appropriate, should be applied to projects which received 1987-1989 credit allocations. In order to assure that no tenant would be burdened by this change, this change should be effected only upon the vacancy of a unit. We are pleased that the Committee included this amendment in its version of H.R. 11 last year.

Furthermore, for the reasons which are outlined in the testimony presented by the Council for Rural Housing and Development, we strongly support the proposal to make retroactive the modification enacted in 1990 with respect to rent rules for FmHA Section 515 projects.

Credit Carryforward Rules Should Be Clarified

In 1989, the Congress wisely adopted an amendment which permitted state housing agencies to carry forward unused credit authority for at least one year. This change meant that states were not under a "use it or lost it" pressure at the end of the year, thereby avoiding situations which forced states to make allocations in order not to lose a portion of their allocation authority. The Treasury Department has adopted an interpretation of the law which we do not believe was intended by the drafters of the legislation and which will re-create this pressure at the end of each year (assuming that the program is extended).

The Senate amendment to H.R. 11 (1992) contained a provision which would constructively address this problem and we urge its adoption or passage of alternative legislation which will deal with this issue.

Alternative to Recapture Bonds

The posting of a bond to avoid recapture of the tax credit contained in Section 42(j)(6) has not proved workable in practice. To our knowledge there are no companies which are issuing such bonds, despite the repeated attempts by owners of tax credit projects to obtain them. Without an alternative mechanism, a developer, or investor which transfers its interest, where the property still remains in compliance, will suffer recapture of prior credits taken.

The most practical solution would be to treat all partnerships as if they were subject to the rule in Section 42(j)(5), the "large" partnership rule. Moreover, the disposition of more than a fifty percent interest in the capital and profits in a twelve month period should not be treated in a different manner than the disposition of a less than fifty percent interest.

The result of this amendment will put the risk of recapture in the event of future noncompliance on the partnership which owns the property, and on the new partner that purchases an old partner's interest. It is the partnership and this new partner that is in control of the property and can best keep the property in compliance. Moreover, if there is a greater risk which the new partner now bears, this can be a factor in the price to be paid for the partnership interest.

If there is a concern over the increased liability of a new partner for recapture based on the number of years the interest was held by an old partner, this could be addressed by having the old partner and new partner in a partnership with less than thirty-five partners file a joint election to have this amendment apply to the partnership.

Additional Changes

There are several additional areas which the Committee should address with corrective legislation.

First, under present law, the Secretary of the Treasury may grant a waiver of the ten year placed in service rule for the acquisition credit for certain buildings in order to avoid a mortgage assignment or a claim against HUD or FmHA, but only with respect to certain HUD and FmHA programs. The list of programs which can be the subject of a waiver should be expanded to include the HUD Section 221(d)(4) mortgage insurance program. Projects insured under a very similar program, Section 221(d)(3), are already eligible for the waiver. There is no reason not to allow this discretionary waiver for Section 221(d)(4) projects, which often serve a very similar population, if it can be demonstrated that use of the credit will avert an insurance claim or assignment against the Federal government. Again, this change was included in the Senate amendment to H.R. 11.

Second, those wishing to preserve historic properties by converting them into low-income housing tax credit projects are discouraged from doing so by an anomaly in the law. In 1989, the Congress repealed a provision that had prohibited investors with incomes of over \$200,000-\$250,000 from utilizing some or all of the low-income credit. However, it left in place a similar provision with respect to the historic rehabilitation credit. Most publicly offered partnerships which invest in low-income credit properties have a number of investors whose incomes are more than \$200,000 and thus are unable to utilize historic credits. The result is that these investment partnerships are not particularly interested in historic credit/low-income housing credit projects. Those developing such projects, knowing that many of their potential investors will be uninterested in historic credits, have no incentive to attempt to preserve these properties' historic features by utilizing the historic credit. There is no reason to maintain this distinction between credits;

at a minimum, the $200,000-$250,000 income phase-out rule should be repealed for properties which are eligible for and receive both the historic and low-income credits.

Third, the rules pertaining to tenancy by students should be modified, consistent with the Senate amendment to H.R. 11. That provision permitted occupancy by full-time student who are single parents who are not, and whose children are not, dependents of others. This modification is needed to eliminate unfair discrimination against such families, who are often very much in need of housing.

Fourth, the Senate amendment also contained a proposal to include community service facilities in eligible basis under certain circumstances. We believe this is a useful change but we object to limiting this provision only to buildings located in qualified census tracts. There is no rational reason to impose this limitation -- community service buildings (e.g., day care centers) serve an equally legitimate function regardless of their location within or outside of a qualified census tract.

PROPOSALS MADE BY OTHER GROUPS

Mr. Chairman, the National Low Income Housing Coalition has submitted a number of proposals for the Committee's consideration. We have great respect for NLIHC; they have been tireless advocates for housing and everyone is this industry owes them a great deal of gratitude for their efforts. We appreciate NLIHC's endorsement of a permanent extension of the tax credit.

While we support several of their proposed modifications, we have serious reservations about other suggestions. We have no objection to the proposal to prohibit discrimination against subsidy holders (although we know of no instances where such discrimination is practiced). With respect to requirements for fair housing compliance, in concept we have no objection to this proposal, although we reserve final judgment on this until we are able to review actual legislative language. We are concerned that project owners and managers not be subject to conflicting and contradictory requirements. With respect to the "good cause" eviction requirements, we note that the Code, Section 42(h)(6)(E)(ii) appears to provide this relief already. Finally, regarding the suggestion that the right of first refusal provisions be modified, we do not oppose this suggestion, but frankly question its usefulness since few sellers will be willing to waive payment of amounts equal to "exit" taxes upon sale of property. A more useful provision would be for the Code to permit elimination of such taxes if the property were to continue to serve low-income persons for an extended period.

We do have serious concerns about three proposals. First, the suggestion regarding deeper targeting raises a number of questions. While we understand that the targeting provision is supposed to be tied to the existence of additional HUD Section 8 subsidies, we seriously question whether such subsidies will be made available, given federal budget realities. In addition, even if such subsidies were available, in order to be financially feasible, the Section 8 assistance would have to be directed only to projects which would commit to this deeper targeting. This would involve a cumbersome coordination process involving HUD, which does not have the staff resources to deal with this allocation of Section 8. Finally, to be meaningful, the subsidies would have to be committed for as long as the low-income use restriction exists, i.e., a minimum of 30 years. Congress is not appropriating funds for 30 year Section 8 contracts. Thus, while in concept "deeper" targeting appears to be worthwhile, there are a host of issues that must be confronted and solved prior to implementing such a substantial amendment to the program. Without resolution, the implementation of this proposal could have a devastating financial impact on low-income housing developments.

In short, without additional subsidy, this proposal makes no financial sense; tying deeper targeting to the existence of Section 8 assistance is unrealistic.

Second, the proposal to mandate that Uniform Relocation Act (URA) benefits be provided must be carefully studied before being adopted. The NLIHC has cited no statistics indicating that a problem exists which needs to be addressed. The provision of URA benefits can have a substantial economic impact on project finances. We urge the Committee to study this proposal thoroughly before recommending this potentially major change to the program.

Third, the suggestion that low-income use be extended to 55 years is troubling. It is unrealistic to believe that the existence of a ten year subsidy, the tax credit, will be sufficient to carry low-income housing developments for 55 years. States are in the best position to judge, on a case-by-case basis, whether other assistance which may exist for a particular project, will be adequate to make it possible to extend low-income restrictions for this period. Indeed, the Code already requires States to provide a preference in the allocation process for projects serving tenants for the longest periods. (Code Section 42(m)(1)(B)(ii)(II).) NLIHC's reliance on California as an example of how 55-year compliance can be feasible ignores the fact that California also has a number of state assistance programs which subsidize these projects. For Congress to mandate 55 year compliance across the board for all tax credit properties without considering whether there exists other forms of assistance which are necessary to make this compliance financially feasible, is a prescription for disaster. The present preference system is working well and should be maintained without amendment.

* * * * * * *

Thank you again for this opportunity to submit this statement.

EXHIBIT A

Summary Schedule

	Scenario #1	Scenario #2	Scenario #3	Scenario #4	Scenario #5	Scenario #6	Scenario #7
Adjusted Gross Income	$78,000	$100,000	$150,000	$200,000	$250,000	$300,000	$500,000
Current Rates							
Assuming taxpayer receives $7,000 of LIHTC, LIHTC Not Currently Useable:							
Married w/ 2 children	$2,616 *	$4,509	$3,259	$1,820	$1,289	$1,050	N/A
Single Adult	$3,398	$2,466	$1,239	$1,626	$2,071	$756	N/A
Proposed Rates							
Assuming taxpayer receives $7,000 of LIHTC, LIHTC Not Currently Useable:							
Married w/ 2 children	$1,776 *	$4,109	$3,759	$2,836	$1,517	$1,312	$0
Single Adult	$2,108	$1,616	$1,420	$832	$984	$1,619	$0

* Assumes taxpayer limited to an allowable credit of $4,720 based on lower tax bracket.

ASSUMPTIONS– 1993 CURRENT RATES

(1) Single adult
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions – $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions :

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000

(8) Altern. Min Tax Rate 24%
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

Rate Schedule	Tax Rate	Bracket Tax
0 – $22,100	15%	3,315
$22,100 – $53,500	28%	8,792
$53,500 and up	31%	12,107

Scenario #1

Adjusted Gross Income	78,000	
Taxes	9,240	
Personal Exemptions	2,350	
Mortgage Interest	15,000	
Taxable Income	$51,410	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$51,410	
Regular Tax before Low Income Tax Credits (LIHTC)	$11,522	
LIHTC	($7,000)	
Net Regular Tax		$4,522
Alternative Minimum Tax Taxable Income	$51,410	
Exclusions and Preferences		
Taxes	$9,240	
Personal Exemptions	$2,350	
	$63,000	
AMT Exemptions	($30,000)	
AMTI	$33,000	
AMT @ 24.00%		$7,920
Excess over Regular Tax = LIHTC Not Currently Useable		$3,398

Scenario #2

Adjusted Gross Income	100,000	
Taxes	11,000	
Personal Exemptions	2,350	
Mortgage Interest	15,000	
Taxable Income	$71,650	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$71,650	
Regular Tax before Low Income Tax Credits (LIHTC)	$17,734	
LIHTC	($7,000)	
Net Regular Tax		$10,734
Alternative Minimum Tax Taxable Income	$71,650	
Exclusions and Preferences		
Taxes	$11,000	
Personal Exemptions	$2,350	
	$85,000	
Exemptions	($30,000)	
AMTI	$55,000	
AMT @ 24.00%		$13,200
Excess over Regular Tax = LIHTC Not Currently Useable		$2,466

Scenario #3

Adjusted Gross Income	150,000	
Taxes	16,000	
Personal Exemptions	2,350	
Mortgage Interest	20,000	
Taxable Income	$111,650	
Phase out of exempt	940	
Phase out of deductions	1,247	
Revised Taxable Income	$113,837	
Regular Tax before Low Income Tax Credits (LIHTC)	$30,811	
LIHTC	($7,000)	
Net Regular Tax		$23,811
Alternative Minimum Tax Taxable Income	$113,837	
Exclusions and Preferences		
Taxes	$14,753	
Personal Exemptions	$1,410	
	$130,000	
Exemptions	($25,625)	
AMTI	$104,375	
AMT @ 24.00%		$25,050
Excess over Regular Tax = LIHTC Not Currently Useable		$1,239

ASSUMPTIONS – 1993 CURRENT RATES

(1) Single adult
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions – $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions:

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000

(8) Altern. Min Tax Rate 24%
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

Rate Schedule	Tax Rate	Bracket Tax
0 – $22,100	15%	3,315
$22,100 – $53,500	28%	8,792
$53,500 and up	31%	12,107

Scenario #4

Adjusted Gross Income	200,000	
Taxes	21,000	
Personal Exemptions	2,350	
Mortgage Interest	25,000	
Taxable Income	$151,650	
Phase out of exempt	1,739	
Phase out of deductions	2,747	
Revised Taxable Income	$156,136	
Regular Tax before Low Income Tax Credits (LIHTC)	$43,924	
LIHTC	($7,000)	
Net Regular Tax		$36,924
Alternative Minimum Tax Taxable Income	$156,136	
Exclusions and Preferences		
Taxes	$18,253	
Personal Exemptions	$611	
	$175,000	
Exemptions	($14,375)	
AMTI	$160,625	
AMT @ 24.00%		$38,550
Excess over Regular Tax = LIHTC Not Currently Useable		$1,626

Scenario #5

Adjusted Gross Income	250,000	
Taxes	26,000	
Personal Exemptions	2,350	
Mortgage Interest	30,000	
Taxable Income	$191,650	
Phase out of exempt	2,350	
Phase out of deductions	4,247	
Revised Taxable Income	$198,247	
Regular Tax before Low Income Tax Credits (LIHTC)	$56,979	
LIHTC	($7,000)	
Net Regular Tax		$49,979
Alternative Minimum Tax Taxable Income	$198,247	
Exclusions and Preferences		
Taxes	$21,753	
Personal Exemptions	$0	
	$220,000	
Exemptions	($3,125)	
AMTI	$216,875	
AMT @ 24.00%		$52,050
Excess over Regular Tax = LIHTC Not Currently Useable		$2,071

Scenario #6

Adjusted Gross Income	300,000	
Taxes	31,000	
Personal Exemptions	2,350	
Mortgage Interest	35,000	
Taxable Income	$231,650	
Phase out of exempt	2,350	
Phase out of deductions	5,747	
Revised Taxable Income	$239,747	
Regular Tax before Low Income Tax Credits (LIHTC)	$69,844	
LIHTC	($7,000)	
Net Regular Tax		$62,844
Alternative Minimum Tax Taxable Income	$239,747	
Exclusions and Preferences		
Taxes	$25,253	
Personal Exemptions	$0	
	$265,000	
Exemptions	$0	
AMTI	$265,000	
AMT @ 24.00%		$63,600
Excess over Regular Tax = LIHTC Not Currently Useable		$756

ASSUMPTIONS – 1993 PROPOSED RATES

(1) Single adult
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions – $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions :

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000
		Scenario #7	$500,000

(8) Altern. Min Tax Rate 26% through $175,000, 28% above
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

	Tax Rate	Bracket Tax
0 – $22,100	15%	3,315
$22,100 – $53,500	28%	8,792
$53,500 – $115,000	31%	19,065
$115,000 – $250,000	36%	48,600
$250,000 and up	39.6%	

(11) AMT Exemption $37,500: Phase out of exemption assumed to be the same as current law (25% of AMTI over $112,500).

Scenario #1

Adjusted Gross Income	78,000	
Taxes	9,240	
Personal Exemptions	2,350	
Mortgage Interest	15,000	
Taxable Income	$51,410	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$51,410	
Regular Tax before Low Income Tax Credits (LIHTC)	$11,522	
LIHTC	($7,000)	
Net Regular Tax		$4,522
Alternative Minimum Tax Taxable Income	$51,410	
Exclusions and Preferences		
Taxes	$9,240	
Personal Exemptions	$2,350	
	$63,000	
AMT Exemptions	($37,500)	
AMTI	$25,500	
AMT @ 26.00%		$6,630
Excess over Regular Tax = LIHTC Not Currently Useable		[$2,108]

Scenario #2

Adjusted Gross Income	100,000	
Taxes	11,000	
Personal Exemptions	2,350	
Mortgage Interest	15,000	
Taxable Income	$71,650	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$71,650	
Regular Tax before Low Income Tax Credits (LIHTC)	$17,734	
LIHTC	($7,000)	
Net Regular Tax		$10,734
Alternative Minimum Tax Taxable Income	$71,650	
Exclusions and Preferences		
Taxes	$11,000	
Personal Exemptions	$2,350	
	$85,000	
Exemptions	($37,500)	
AMTI	$47,500	
AMT @ 26.00%		$12,350
Excess over Regular Tax = LIHTC Not Currently Useable		[$1,616]

Scenario #3

Adjusted Gross Income	150,000	
Taxes	16,000	
Personal Exemptions	2,350	
Mortgage Interest	20,000	
Taxable Income	$111,650	
Phase out of exempt	799	
Phase out of deductions	1,247	
Revised Taxable Income	$113,696	
Regular Tax before Low Income Tax Credits (LIHTC)	$30,768	
LIHTC	($7,000)	
Net Regular Tax		$23,768
Alternative Minimum Tax Taxable Income	$113,696	
Exclusions and Preferences		
Taxes	$14,753	
Personal Exemptions	$1,551	
	$130,000	
Exemptions	($33,125)	
AMTI	$96,875	
AMT @ 26.00%		$25,188
Excess over Regular Tax = LIHTC Not Currently Useable		[$1,420]

ASSUMPTIONS – 1993 PROPOSED RATES

(1) Single adult
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions – $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions:

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000
		Scenario #7	$500,000

(8) Altern. Min Tax Rate 26% through $175,000, 28% above
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

Rate Schedule	Tax Rate	Bracket Tax
0 – $22,100	15%	3,315
$22,100 – $53,500	28%	8,792
$53,500 – $115,000	31%	19,065
$115,000 – $250,000	36%	48,600

(11) AMT Exemption $37,500. Phase out of exemption assumed to be the same as current law (25% of AMTI over $112,500)

Scenario #4

Adjusted Gross Income	200,000	
Taxes	21,000	
Personal Exemptions	2,350	
Mortgage Interest	25,000	
Taxable Income	$151,650	
Phase out of exempt	1,739	
Phase out of deductions	2,747	
Revised Taxable Income	$156,136	
Regular Tax before Low Income Tax Credits (LIHTC)	$45,981	
LIHTC	($7,000)	
Net Regular Tax		$38,981
Alternative Minimum Tax Taxable Income	$156,136	
Exclusions and Preferences		
Taxes	$18,253	
Personal Exemptions	$611	
	$175,000	
Exemptions	($21,875)	
AMTI	$153,125	
AMT @ 26.00%		$39,813
Excess over Regular Tax = LIHTC		
Not Currently Useable		$832

Scenario #5

Adjusted Gross Income	250,000	
Taxes	26,000	
Personal Exemptions	2,350	
Mortgage Interest	30,000	
Taxable Income	$191,650	
Phase out of exempt	2,350	
Phase out of deductions	4,247	
Revised Taxable Income	$198,247	
Regular Tax before Low Income Tax Credits (LIHTC)	$61,141	
LIHTC	($7,000)	
Net Regular Tax		$54,141
Alternative Minimum Tax Taxable Income	$198,247	
Exclusions and Preferences		
Taxes	$21,753	
Personal Exemptions	$0	
	$220,000	
Exemptions	($10,625)	
AMTI	$209,375	
AMT @ Blended rate		$55,125
Excess over Regular Tax = LIHTC		
Not Currently Useable		$984

Scenario #6

Adjusted Gross Income	300,000	
Taxes	31,000	
Personal Exemptions	2,350	
Mortgage Interest	35,000	
Taxable Income	$231,650	
Phase out of exempt	2,350	
Phase out of deductions	5,747	
Revised Taxable Income	$239,747	
Regular Tax before Low Income Tax Credits (LIHTC)	$76,081	
LIHTC	($7,000)	
Net Regular Tax		$69,081
Alternative Minimum Tax Taxable Income	$239,747	
Exclusions and Preferences		
Taxes	$25,253	
Personal Exemptions	$0	
	$265,000	
Exemptions	$0	
AMTI	$265,000	
AMT @ Blended rate		$70,700
Excess over Regular Tax = LIHTC		
Not Currently Useable		$1,619

Scenario #7

Adjusted Gross Income	500,000	
Taxes	51,000	
Personal Exemptions	2,350	
Mortgage Interest	55,000	
Taxable Income	$391,650	
Phase out of exempt	2,350	
Phase out of deductions	11,747	
Revised Taxable Income	$405,747	
Regular Tax before Low Income Tax Credits (LIHTC)	$141,448	
LIHTC	($7,000)	
Net Regular Tax		$134,448
Alternative Minimum Tax Taxable Income	$405,747	
Exclusions and Preferences		
Taxes	$39,253	
Personal Exemptions	$0	
	$445,000	
Exemptions	$0	
AMTI	$445,000	
AMT @ Blended rate		$121,100
Excess over Regular Tax = LIHTC		
Not Currently Useable		$0

ASSUMPTIONS – 1995 CURRENT RATES

(1) Married couple with 2 children
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions – $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions :

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000

(8) Altern. Min Tax Rate 24%
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

Rate Schedule	Tax Rate	Bracket Tax
0 ~ $36,900	15%	5,535
$36,900 – $89,150	28%	14,630
$89,150 and up	31%	20,165

Scenario #1

Adjusted Gross Income	78,000	
Taxes	9,240	
Personal Exemptions	9,400	
Mortgage Interest	15,000	
Taxable Income	$44,360	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$44,360	
Regular Tax before Low Income Tax Credits (LIHTC)	$7,624	
LIHTC	($4,720)	
Net Regular Tax		$2,904
Alternative Minimum Tax Taxable Income	$44,360	
Exclusions and Preferences		
Taxes	$9,240	
Personal Exemptions	$9,400	
	$63,000	
AMT Exemptions	($40,000)	
AMTI	$23,000	
AMT @ 24.00%		$5,520
Excess over Regular Tax = LIHTC Not Currently Useable		$2,616

Scenario #2

Adjusted Gross Income	100,000	
Taxes	11,000	
Personal Exemptions	9,400	
Mortgage Interest	15,000	
Taxable Income	$64,600	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$64,600	
Regular Tax before Low Income Tax Credits (LIHTC)	$13,291	
LIHTC	($7,000)	
Net Regular Tax		$6,291
Alternative Minimum Tax Taxable Income	$64,600	
Exclusions and Preferences		
Taxes	$11,000	
Personal Exemptions	$9,400	
	$85,000	
Exemptions	($40,000)	
AMTI	$45,000	
AMT @ 24.00%		$10,800
Excess over Regular Tax = LIHTC Not Currently Useable		$4,509

Scenario #3

Adjusted Gross Income	150,000	
Taxes	16,000	
Personal Exemptions	9,400	
Mortgage Interest	20,000	
Taxable Income	$104,600	
Phase out of exempt	0	
Phase out of deductions	1,247	
Revised Taxable Income	$105,847	
Regular Tax before Low Income Tax Credits (LIHTC)	$25,341	
LIHTC	($7,000)	
Net Regular Tax		$18,341
Alternative Minimum Tax Taxable Income	$105,847	
Exclusions and Preferences		
Taxes	$14,753	
Personal Exemptions	$9,400	
	$130,000	
Exemptions	($40,000)	
AMTI	$90,000	
AMT @ 24.00%		$21,600
Excess over Regular Tax = LIHTC Not Currently Useable		$3,259

ASSUMPTIONS– 1993 CURRENT RATES

(1) Married couple with 2 children
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions– $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions:

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000

(8) Altern. Min Tax Rate 24%
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

Rate Schedule	Tax Rate	Bracket Tax
0 – $36,900	15%	5,535
$36,900 – $89,150	28%	14,630
$89,150 and up	31%	20,165

Scenario #4

Adjusted Gross Income	200,000	
Taxes	21,000	
Personal Exemptions	9,400	
Mortgage Interest	25,000	
Taxable Income	$144,600	
Phase out of exempt	2,820	
Phase out of deductions	2,747	
Revised Taxable Income	$150,167	
Regular Tax before Low Income Tax Credits (LIHTC)	$39,080	
LIHTC	($7,000)	
Net Regular Tax		$32,080
Alternative Minimum Tax Taxable Income	$150,167	
Exclusions and Preferences		
Taxes	$18,253	
Personal Exemptions	$6,580	
	$175,000	
Exemptions	($33,750)	
AMTI	$141,250	
AMT @ 24.00%		$33,900
Excess over Regular Tax = LIHTC Not Currently Useable		$1,820

Scenario #5

Adjusted Gross Income	250,000	
Taxes	26,000	
Personal Exemptions	9,400	
Mortgage Interest	30,000	
Taxable Income	$184,600	
Phase out of exempt	6,580	
Phase out of deductions	4,247	
Revised Taxable Income	$195,427	
Regular Tax before Low Income Tax Credits (LIHTC)	$53,111	
LIHTC	($7,000)	
Net Regular Tax		$46,111
Alternative Minimum Tax Taxable Income	$195,427	
Exclusions and Preferences		
Taxes	$21,753	
Personal Exemptions	$2,820	
	$220,000	
Exemptions	($22,500)	
AMTI	$197,500	
AMT @ 24.00%		$47,400
Excess over Regular Tax = LIHTC Not Currently Useable		$1,289

Scenario #6

Adjusted Gross Income	300,000	
Taxes	31,000	
Personal Exemptions	9,400	
Mortgage Interest	35,000	
Taxable Income	$224,600	
Phase out of axempt	9,400	
Phase out of deductions	5,747	
Revised Taxable Income	$239,747	
Regular Tax before Low Income Tax Credits (LIHTC)	$66,850	
LIHTC	($7,000)	
Net Regular Tax		$59,850
Alternative Minimum Tax Taxable Income	$239,747	
Exclusions and Preferences		
Taxes	$25,253	
Personal Exemptions	$0	
	$265,000	
Exemptions	($11,250)	
AMTI	$253,750	
AMT @ 24.00%		$60,900
Excess over Regular Tax = LIHTC Not Currently Useable		$1,050

ASSUMPTIONS– 1995 PROPOSED RATES

(1) Married couple with 2 children
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions– $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions :

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000
		Scenario #7	$500,000

(8) Altern. Min Tax Rate 26% through $175,000, 28% above
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

Rate Schedule	Tax Rate	Bracket Tax
0 – $36,900	15%	5,535
$36,900 – $89,150	28%	14,630
$89,150 – $140,000	31%	15,764
$140,000 – $250,000	36%	39,600
$250,000 and up	39.6%	

(11) AMT Exemption $45,000: Phase out of exemption assumed to be the same as current law (25% of AMTI over $150,000).

Scenario #1

Adjusted Gross Income	78,000	
Taxes	9,240	
Personal Exemptions	9,400	
Mortgage Interest	15,000	
Taxable Income	$44,360	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$44,360	
Regular Tax before Low Income Tax Credits (LIHTC)	$7,624	
LIHTC	($4,720)	
Net Regular Tax		$2,904
Alternative Minimum Tax Taxable Income	$44,360	
Exclusions and Preferences		
Taxes	$9,240	
Personal Exemptions	$9,400	
	$63,000	
AMT Exemptions	($45,000)	
AMTI	$18,000	
AMT @ 26.00%		$4,680
Excess over Regular Tax = LIHTC Not Currently Useable		$1,776

Scenario #2

Adjusted Gross Income	100,000	
Taxes	11,000	
Personal Exemptions	9,400	
Mortgage Interest	15,000	
Taxable Income	$64,600	
Phase out of exempt	0	
Phase out of deductions	0	
Revised Taxable Income	$64,600	
Regular Tax before Low Income Tax Credits (LIHTC)	$13,291	
LIHTC	($7,000)	
Net Regular Tax		$6,291
Alternative Minimum Tax Taxable Income	$64,600	
Exclusions and Preferences		
Taxes	$11,000	
Personal Exemptions	$9,400	
	$85,000	
Exemptions	($45,000)	
AMTI	$40,000	
AMT @ 26.00%		$10,400
Excess over Regular Tax = LIHTC Not Currently Useable		$4,109

Scenario #3

Adjusted Gross Income	150,000	
Taxes	16,000	
Personal Exemptions	9,400	
Mortgage Interest	20,000	
Taxable Income	$104,600	
Phase out of exempt	0	
Phase out of deductions	1,247	
Revised Taxable Income	$105,847	
Regular Tax before Low Income Tax Credits (LIHTC)	$25,341	
LIHTC	($7,000)	
Net Regular Tax		$18,341
Alternative Minimum Tax Taxable Income	$105,847	
Exclusions and Preferences		
Taxes	$14,753	
Personal Exemptions	$9,400	
	$130,000	
Exemptions	($45,000)	
AMTI	$85,000	
AMT @ 26.00%		$22,100
Excess over Regular Tax = LIHTC Not Currently Useable		$3,759

ASSUMPTIONS – 1993 PROPOSED RATES

(1) Married couple with 2 children
(2) State Tax Rate – 8%
(3) Real estate taxes – $3,000 as the base case, add $1,000 for each additional $50,000 of income
(4) No other preference items or exclusions
(5) Taxpayers are receiving $7,000 of Low Income Housing Tax Credits (LIHTC)
(6) Mortgage interest deductions – $15,000 as the base case, add $5,000 for each additional $50,000 of income
(7) Income Assumptions.

Scenario #1	$78,000	Scenario #4	$200,000
Scenario #2	$100,000	Scenario #5	$250,000
Scenario #3	$150,000	Scenario #6	$300,000
		Scenario #7	$500,000

(8) Altern. Min Tax Rate 26% through $175,000, 28% above
(9) Personal Exemptions of $2,350/ exemption
(10) Rate Schedule

Rate Schedule	Tax Rate	Bracket Tax
0 – $36,900	15%	5,535
$36,900 – $89,150	28%	14,630
$89,150 – $140,000	31%	15,764
$140,000 – $250,000	36%	38,600
$750,000 and up	39.6%	

(11) AMT Exemption $45,000. Phase out of exemption assumed to be the same as current law (25% of AMTI over $150,000)

Scenario #4

Adjusted Gross Income	200,000	
Taxes	21,000	
Personal Exemptions	9,400	
Mortgage Interest	25,000	
Taxable Income	$144,800	
Phase out of exempt	7,820	
Phase out of deductions	2,747	
Revised Taxable Income	$150,187	
Regular Tax before Low Income Tax Credits (LIHTC)	$39,580	
LIHTC	($7,000)	
Net Regular Tax		$32,580
Alternative Minimum Tax Taxable Income	$150,187	
Exclusions and Preferences		
Taxes	$18,253	
Personal Exemptions	$6,580	
	$175,000	
Exemptions	($38,750)	
AMTI	$136,250	
AMT @ 26.00%		$35,425
Excess over Regular Tax = LIHTC Not Currently Useable		$2,836

Scenario #5

Adjusted Gross Income	750,000	
Taxes	26,000	
Personal Exemptions	9,400	
Mortgage Interest	30,000	
Taxable Income	$184,600	
Phase out of exempt	6,580	
Phase out of deductions	4,247	
Revised Taxable Income	$195,427	
Regular Tax before Low Income Tax Credits (LIHTC)	$55,883	
LIHTC	($7,000)	
Net Regular Tax		$48,883
Alternative Minimum Tax Taxable Income	$195,427	
Exclusions and Preferences		
Taxes	$21,753	
Personal Exemptions	$2,820	
	$220,000	
Exemptions	($27,500)	
AMTI	$192,500	
AMT @ Blended Rate		$50,400
Excess over Regular Tax = LIHTC Not Currently Useable		$1,517

Scenario #6

Adjusted Gross Income	300,000	
Taxes	31,000	
Personal Exemptions	9,400	
Mortgage Interest	35,000	
Taxable Income	$224,600	
Phase out of exempt	9,400	
Phase out of deductions	5,747	
Revised Taxable Income	$239,747	
Regular Tax before Low Income Tax Credits (LIHTC)	$71,838	
LIHTC	($7,000)	
Net Regular Tax		$64,838
Alternative Minimum Tax Taxable Income	$239,747	
Exclusions and Preferences		
Taxes	$25,253	
Personal Exemptions	$0	
	$265,000	
Exemptions	($16,250)	
AMTI	$248,750	
AMT @ Blended Rate		$66,150
Excess over Regular Tax = LIHTC Not Currently Useable		$1,312

Scenario #7

Adjusted Gross Income	500,000	
Taxes	51,000	
Personal Exemptions	9,400	
Mortgage Interest	55,000	
Taxable Income	$384,600	
Phase out of exempt	9,400	
Phase out of deductions	11,747	
Revised Taxable Income	$405,747	
Regular Tax before Low Income Tax Credits (LIHTC)	$137,205	
LIHTC	($7,000)	
Net Regular Tax		$130,205
Alternative Minimum Tax Taxable Income	$405,747	
Exclusions and Preferences		
Taxes	$39,253	
Personal Exemptions	$0	
	$445,000	
Exemptions	$0	
AMTI	$445,000	
AMT @ Blended Rate		$121,100
Excess over Regular Tax = LIHTC Not Currently Useable		$0

EXHIBIT B

February 14, 1993

I'm one of your limited partners.

I've been receiving the maximum Low Housing credits approved by Congress as an incentive for the development of such properties.

I gather that President Clinton is giving serious consideration to increasing the Alternative Minimum Tax ("ATM") rate.

I have not been nor do I expect to be subject to the AMT; however, an increase in the AMT rate would in effect deprive me of all or most of the L.H. credits.

That is true because (under existing law) such credits may be taken only up to the difference between the taxpayer's regular and AMT taxes.

For 1990 and earlier years, the 22% AMT rate easily allowed me full use of my credits.

But the higher 24% rate for 1991 (and 1992) so narrowed the difference between the two taxes that I was just barely able to use the full credits.

Obviously another increase in the AMT rate would further narrow or even eliminate the difference between the two taxes and thus prevent my use of most of all of those credits.

I'm seventy and retired. I'm not wealthy - if anything, I might be considered on the high side of middle-income. Why then is this a problem for me? Well, it wouldn't be if I lived in a State that had no or a low income tax. But it so happens I live in a State that has <u>both</u> high income <u>and</u> property taxes.

These taxes are deductible for the regular Federal tax, but not for the AMT tax.

I'm sure that other of your middle-income limited partners in this and similar ventures also face the potential loss of the use of their tax credits - and particularly so if they too are located in States with both high income and property taxes.

What is particularly irritating in all of this is that our Government decided, as a matter of social policy, that something had to be done to increase housing for those on low incomes. It did this by creating an incentive for investment in low-income housing - i.e., tax credits. But for those credits, I would never have put funds on which my retirement depends into such housing. But now the Government appears ready to turn around and say that the taxpayer who bit on that carrot is not to be allowed any return on his money.

I am sure you must be aware of this problem and I would assume you share my concern. Yet, I can't recall ever hearing from you when Congress increased the AMT rate from 22% to 24%, and I certainly have heard nothing from you regarding your views on, and actions you are taking with respect to the current proposal to increase the AMT with it's probable adverse affect on the credits that I and various of your other investors will be able to use.

Are you working on this? Will you be alerting your investors to this problem so they can perhaps contact the appropriate people in the Executive and Legislative branches? And what are you doing in that regard?

Very truly yours,

Name Withheld By Request

STATEMENT ON BEHALF OF THE
NATIONAL MARINE MANUFACTURERS ASSOCIATION

SUBMITTED TO THE COMMITTEE ON WAYS AND
MEANS OF THE U.S. HOUSE OF REPRESENTATIVES
REGARDING REPEAL OF THE 10% FEDERAL EXCISE TAX ON THE
PRICE OF BOATS COSTING MORE THAN $100,000

President Clinton and the Members of the Committee deserve much credit for considering opportunities to stimulate job growth in the U.S. economy. On behalf of the members of the National Marine Manufacturers Association, we want to bring to the Committee's attention one particular opportunity to restore thousands of jobs and rescue hundreds of small businesses at little or no cost to the U.S. taxpayers: repeal of the so-called "luxury" excise tax on boats. We offer the following comments regarding repeal of this tax:

Impact on Job Growth and the U.S. Boat Building Industry

The boat tax has directly resulted in 25,000 to 30,000 lost jobs in the United States. Although admittedly the recession has caused many job losses in the boat building industry, the economic recession does not alone fully explain the loss of jobs and financial distress in the U.S. boat building industry. There was a 55% decline in the number of large expensive motor cruisers shipped during 1992 compared to 1990. The decline in sales of smaller boats (virtually none of which are subject to the tax) during the same period was only 15%. The greater steepness of the decline in large boat sales compared to the decline in small boat sales is the direct result of the boat tax.

Because larger boats are often manufactured by small, specialized U.S. companies, the tax has triggered a wave of bankruptcies. A survey by NMMA reveals that approximately 33% of all boat builders are on COD terms with their suppliers. The percentage for the large recreational boat builders severely affected by this tax is much higher. Widespread use of such arrangements is further evidence of the industry's financial distress.

Impact on Foreign Trade

This tax is having a negative impact on the international competitive position of the U.S. boat building industry. The U.S. boat building industry has a reputation as the world leader in building such boats. The continuing deleterious effect of this tax imperils our country's leadership position in building large recreational boats.

In 1990, the United States exported $257.4 million in large recreational boats. The decline in domestic sales resulting from the boat excise tax drives up production costs per unit, thus making U.S.-manufactured boats less competitive abroad. As more and more U.S. companies go out of business, it becomes less and less likely that the U.S. industry will be able to maintain its preeminence. It is important to repeal this tax quickly before more damage is done to this uniquely American business.

Impact on Revenues

Depending on how the impact of the tax is analyzed, repeal would increase revenues significantly or decrease revenues

negligibly. A dynamic revenue analysis[1/] would show that the boat tax is a significant net revenue loser. In one and one-half years the Internal Revenue Service has collected only $16 million in revenues which is less than originally projected. The Joint Committee on Taxation estimates that it will raise annual net revenues of only $25 million in fiscal years 1994-1997.

Conclusion

Put simply, the boat tax, which was intended to tax wealthy boat owners, has had the unintended effect of displacing 25,000 to 30,000 skilled working class citizens and has significantly contributed to the decline of a great American success story. We ask the Committee to include repeal of the boat tax, which has cost so many Americans their jobs, in the mark up of the President's tax proposals.

1/ A dynamic analysis would take into account the reduced federal and state income taxes, social security taxes, and medicare taxes and the expenditures for unemployment benefits caused by unemployed workers.

TESTIMONY OF BOB BERGLAND
National Rural Electric Cooperative Association

Mr. Chairman, Members of the Committee: This statement is submitted by the National Rural Electric Cooperative Association (NRECA) on behalf of the 25 million consumers served by 1,000 consumer-owned, nonprofit rural electric systems in 46 states.

INTRODUCTION

Rural electric systems continue to provide high-quality, central station electric service while operating under the traditional disadvantages of low consumer density, distance, weather and high investment per consumer.

Rural electric systems continue to confront another obstacle, that of rate disparity. Seventy percent of rural electric systems' rates are higher than their neighboring utilities. Rates are higher for several reasons -- much of rural electric systems' generating capacity was built in response to the energy crisis of the 1970s and during a period of high interest and rapid inflation; it was built to comply with the Clean Air Act of 1972, and as a consequence has state-of-the-art pollution control; rural electric systems serve primarily residential consumers and do not enjoy the ratio of industrial and commercial loads of municipal and investor-owned utilities.

The Clinton Administration has proposed for FY 1994 and subsequent years an energy tax based on the content of energy as measured in British Thermal Units (Btus) that will be an additional burden for rural electric consumers.

We are concerned that if such a tax is to be levied, it be applied fairly and that it not unduly burden rural Americans.

In addition, such a tax should be flexible enough in its design and administration to accommodate the various energy sources of electricity generation in this country. For example, about 75 percent of the generating capacity owned by rural electric systems is coal-fired, which means that rural electric system are very dependent on coal as a fuel source. However, a small but growing number of systems are investing in the use of photovoltaic cells to power remote irrigation and stock watering facilities. The proposed tax must not act as a drag on developing technologies in energy production and use.

At our Annual Meeting in Dallas in February, delegates passed a resolution addressing this very subject, and I quote from it:

"Because of the federal government's burgeoning budget deficit, there have been reductions in assistance to state and local governments, resulting in pressures at the federal, state and local level to find revenues. Accordingly there have been numerous revenue raising proposals at all governmental levels.

"We oppose any new federal tax on energy or energy sources that unfairly burden rural electric consumers or negatively impacts national economic growth. . .

"We call upon Congress and the Administration to develop a federal tax structure that increases federal revenues in a manner that will fairly and equitably distribute the burden of federal taxation over all classes of taxpayers."

The nation's rural electric systems commend the Clinton Administration for its willingness to discuss aspects of the tax with the country's energy users and producers. However, we do still have some concerns.

1. Pass-Through Issues

We commend the Secretary of the Treasury for his public acknowledgement that the ultimate users of energy will bear a large

portion of the proposed Btu tax. It can be no other way. Energy is one of the basic "productive inputs" in our economy and as such, must be paid for by all those who use it.

We therefore recommend that no attempt be made to preclude energy suppliers, including rural electric systems, from recording the proposed Btu tax's impact on a consumer's bill.

We are concerned that the Administration's proposal to couple a utility's pass-through of its Btu tax as a condition to its use of accelerated depreciation and other federal corporate tax incentives will have unintended, deleterious affects. We intend to comment to the Treasury Department on this matter, but we would like to take this opportunity to bring some of these difficulties to the attention of the Committee.

First, NRECA and its member systems are uncertain whether the Internal Revenue Code is the proper instrument with which the federal government should indirectly compel state utility regulators to allow the proposed BTU tax to pass through to the end user of energy. We would hope that a path could be found to allow full pass-through without upsetting the interplay of state and federal powers.

Second, the Administration proposal to change normalization for utilities during the period the proposed Btu tax is not passed through could adversely affect rural electric system consumer-members. Organized as cooperatives or other not-for-profit corporations, rural electric systems are bound to supply power reliably at the lowest possible cost consistent with sound business practices. This operating philosophy sometimes means that rural electric systems purchase power from neighboring utilities to meet some of the rural electric systems' consumer-members' needs. Any attempt to preclude pass-through of the Btu tax at the retail level by removing tax benefits help by regulated investor-owned utilities would only force wholesale rates upward. Heretofore, unexpected wholesale price changes could jeopardize long-standing power supply contracts or delivery arrangements , thus endangering the rural electric systems' ability to reliably supply power.

2. <u>Rural Impact of the Proposed Btu Tax</u>

As stated previously, because rural electric systems are dependent on coal-fired generation, their electricity rates will go up, as will retail rates across the country. However, 70 percent of rural electric systems will continue to have higher rates than neighboring utilities.

Rural consumers also drive longer distances using more fuel and therefore would bear a burden imposed by higher gasoline prices necessitated by the tax.

In addition, independent farmers have virtually no way to "pass through" the increased burdens (direct on fuel consumed in farming and indirect in higher commodity transportation prices and other farming costs) to the "end users" of food and fiber. Their commodities must compete on the world market. One of the reasons American agriculture is so competitive with the rest of the world and why that sector of our economy continues to maintain a positive balance of trade is because agricultural inputs are competitively priced. If the costs of those inputs rise (energy used directly in farming as well as fertilizer, for example), the farmer will have to fully absorb those costs and farm income will decline.

Therefore NRECA recommends that the off-road use of diesel and gasoline in farming be exempted from the proposed Btu tax, or that farmers get a tax credit for their fuel use, similar to the provisions for off-road use embodied in the federal diesel fuel excise tax.

3. Alternative Methods of Energy Production or Generation

The members of NRECA have expressed concerns to the Administration over some innovative energy and fuel generation technologies they are involved in and, on the whole, have been received well and many of their concerns have been answered.

However, we believe that further clarification is needed in the tax treatment of energy generated and used in all kinds of energy storage technologies, not just pumped storage hydroelectric generation, which the Administration proposes to exempt. One NRECA member, Alabama Electric Cooperative (AEC) of Andalusia, Alabama, owns and operates the only compressed-air electric generation facility in the country. AEC employs off-peak electric energy generated from its nearby Lowman plant to compress air into a man-made cavern. That air is later released and superheated with natural gas fired burners during peak times to power generators that produce cheaper electricity. This electricity is cheaper for the consumer-members of AEC's distribution system members because the air was compressed with the cheapest electricity available: off-peak energy. Furthermore, the use of compressed air does not pollute and offers, where applicable, a reliable way to provide what is usually the most expensive electricity: peaking power. We would recommend that electricity generated from compressed air storage be treated identically to electricity generated by pumped-storage hydro and that a credit or exemption as a feedstock be granted for any fuel used to superheat the air.

In addition, we believe that further clarification is needed on the Administration's proposal to exempt fossil fuels used as feedstocks, as well as its proposed exemption for energy used to generate energy or fuel, especially related to fuel cells, batteries, electric thermal storage and other energy storage technologies. For example, fuel cells represent an emerging, cost-competitive technology to produce electricity in some situations.

As a broader concern, we believe that some provision must be made within the proposed framework of any energy tax to reward the wise, efficient use of energy and fuels. A "one size fits all" approach simply will not work. In addition, some decision-making provision must be made for new and emerging technologies.

4. Alternative Methods of Energy Use

NRECA also recommends that some recognition of advanced energy uses called "electrotechnologies" be made under any energy tax framework. Such advanced technologies improve the wise and efficient use of energy by using electricity in applications where it is more efficient than other end-use fuels, such as electric arc furnaces, plasma-fired technology and induction heating.

Further, there has been, in some cases, a 20-year history of encouraging residential end users to heat with electricity using off-peak energy such as dual fuel (dual heat) systems and electric thermal storage units. Such systems allow consumers to use electricity as their primary heating source and switch over to the alternate only during times of peak electricity usage, thereby enabling power suppliers to manage or shave their peaks and make the most efficient use of existing generating capacity. NRECA's members actively participate in these programs and feel strongly that they should not be disadvantaged under any energy tax.

INLAND WATERWAYS FEE

Finally, another proposal to be phased in over the next four years would also affect rural electric rates, and that is an additional $1 per gallon fuel tax to fully recover operation and maintenance costs of the shallow-draft inland navigation system. The current tax of 19 cents per gallon pays for half of inland navigation construction and rehabilitation projects.

This proposal will substantially affect the cost and competitiveness of coal. The increased shipping costs will only serve to raise the cost of coal and will affect a utility's decision on where to purchase the coal. The increased cost will adversely impact rural electric systems that must ship coal from one region of the country to another. These increased costs will be borne by the ultimate consumers, who will also be affected by the increased costs of groceries and raw materials. We would recommend no change in the fee other than that scheduled in current law.

The same resolution cited earlier and approved by voting delegates at NRECA's 1993 Annual Meeting contains the following language: "We oppose . . . any federal tax which punitively targets coal, as compared with the taxation of other fuels used to generate electricity." We believe that this additional fuel tax does target, although perhaps inadvertently, coal.

Again, rural electric systems and their consumers understand all too clearly the implications of huge federal deficits, and we are willing to do our fair share to reduce those deficits.

In conclusion, rural electric systems respectfully ask this Committee and the Congress to ascertain that rural Americans are treated fairly and equitably in any tax proposals to reduce the federal deficit. Rural electric systems and rural electric consumers are willing to do their fair share to deal with budget deficits and ask only to be treated equitably.

Thank you.

1943 1993
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NTMA

National Tooling & Machining Association
9300 Livingston Road Ft. Washington, MD 20744

NTMA POSITION PAPER -- INVESTMENT TAX CREDIT

NTMA POSITION--

Historically used as a stimulus to the economy and to subsidize investment and capital formation, an Investment Tax Credit (ITC) has been proposed by President Clinton as part of his Economic Plan. NTMA supports the Investment Tax Credit not only as a tax incentive to spur immediate industial growth and create jobs, but more importantly as part of a strategic policy that will effect long-term economic growth.

According to a Treasury Department summary, the Administration's small business ITC is a temporary credit at a 7 percent rate for two years and then permanent at 5 percent thereafter. Small business is defined as one with average annual gross receipts of less than $5 million in the three years immediately preceding the taxable year. The incremental ITC for large companies (gross annual receipts over $5 million) is temporary at a rate of 7 percent and is incrementally calculated over a base with caps.

The rate at which tooling and machining companies have been able to invest since the 1986 repeal of the ITC has dropped sharply. A study by the John F. Kennedy School of Government at Harvard concluded that a mere "11 percent of smaller manufacturers are using advanced technology at this time." Reducing capital costs is most important to small tooling and machining industry business owners, most of whose profit margins are under 5 percent of sales. An ITC would represent a downpayment on a machine tool. A permanent ITC is considerably less burdensome in terms of administration than the incremental credit for big business, and would help the majority (67 percent) of NTMA member companies to increase their investment regularly, thereby maintaining a steady pace with advances in technology.

NTMA agrees with the President's support of an ITC, but thinks it should apply to a greater universe of small companies. The federal government small business size standard for our industry is 500 employees; however, because tax regulations are geared to measurements of gross receipts, we feel the Administration's proposal falls short of benefiting a great many small businesses by limiting the permanent ITC to companies with only $5 million in annual gross receipts. The 3,000 NTMA member companies employ an average of only 25 employees, and the $5 million cutoff will exclude a third of them whose gross receipts presently exceed $5 million. A more realistic cap would be at least $15 million. Additionally, it should be noted that the Administration's proposal for small business is a 7 percent ITC for only two years, reverting to 5 percent thereafter. Clearly, if the ITC is to serve as an incentive for long-term economic growth, the credit should be permanent and a 10 percent credit would be more realistic.

For the nation's 360,000 small and medium sized manufacturing firms who exist in a highly competitive environment characterized by hyper-price competition, a 10 percent ITC would allow for long-term investments to become routine and planned. This would increase a small firm's ability to obtain upgraded technologies, and help the U. S. competitive posture in terms of quality, productivity and price. In the absence of continuing investment in productivity, improving job creation is curtailed.

NTMA believes the most effective ITC should be a permanent, 10 percent credit for productive equipment, including CNC-CAD-CAM and CAE equipment used in manufacturing. Used, as well as new equipment, should be eligible.

BACKGROUND--

President Clinton's economic recovery plan has three elements; economic stimulus to create new jobs, long term "public investments" and a deficit reduction plan. His stimulus plan contains a permanent small business ITC and a limited temporary ITC for all businesses.

The ITC first enacted in 1962 at a rate of 7 percent was envisioned as a permanent investment subsidy. It included a basis adjustment -- the cost of the property (which could be depreciated) was reduced by the amount of the credit. This adjustment was repealed in 1964.

In 1966, the ITC was suspended as an anti-inflationary measure. Since then the ITC has been on again and off again.

The ITC was increased to 10 percent in 1975. The Tax Acts of 1976 and 1977 extended the credit because capital formation in the economy was lagging. The 10 percent credit was made permanent in 1978 but repealed by the Tax Reform Act of 1986.

March 1993

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NIAGARA MOHAWK

NIAGARA MOHAWK POWER CORPORATION/111 WASHINGTON AVE., P.O. BOX 591, ALBANY, N.Y. 12201-0591/TELEPHONE (518) 433-5286

Douglas R. McCuen
Vice President
Government and Regulatory Relations

The Honorable Dan Rostenkowski
U.S. House of Representatives
Chairman, Ways & Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Rostenkowski,

Recently, Niagara Mohawk Power Corporation joined five other utilities in writing President Clinton to express our willingness to be constructively engaged in fulfilling the President's goals with respect to the Btu tax. As you know, a detailed outline of the proposal has been sent to the Congress, with specific jurisdiction in your committee. Knowing your important responsibilities on this issue, we would like to make a few observations and suggestions.

I. The current proposal does not consider hydropower as a renewable energy source. This will unfortunately send a problematic message which could have long-term ramifications in future environmental and energy debates. We respectfully suggest that hydropower needs to be considered as renewable, both now and in the foreseeable future.

We are also concerned to hear that the Congress is being lobbied to believe that the hydro industry receives a "subsidy" in its use of the nation's rivers. In New York, such a "subsidy" does exist, and it flows directly to our customers, preserving thousands of jobs in heavy industry throughout Upstate New York. Frankly, we would rather see the Pacific Northwest gain through a downward tax adjustment for hydro than watch these jobs lost to somewhere south of the border.

Thus, we believe if there must be a tax on hydro, it should accurately reflect hydro's high efficiency. The current proposal taxes hydropower at a conversion rate which is approximately the same efficiency rate at which coal plants convert resources to energy. <u>However, the hydro plants operate at a 85%-95% efficiency rate</u>. In the interest of scientific accuracy, environmental benefit and economic fairness, the conversion rate for hydro should be reduced from the proposed 10,315 Btu/kWh to a more appropriate 3,700 Btu/kWh. The revenue impact of this change would only amount to a 2% change in total energy tax revenues collected.

II. We agree with Secretary Bentsen that for the tax "to effectively promote energy conservation, it must be borne by the ultimate consumer." This goal is important not only from the standpoint of energy conservation, but also to prevent the Btu tax from being imposed in such a way that it triggers "piggy back taxes," thereby further increasing the costs of energy to our customers, particularly our industrial base. In fact, we believe the legislation should preclude state and local governments from windfall gains through such mechanisms as New York's Gross Receipts Tax.

Moreover, although we agree the tax should be "passed through," we are very concerned about the normalization approach outlined in the Administration's current proposal. This potentially places utilities in an untenable double jeopardy position. We believe other options should be explored and we would be happy to assist in crafting more suitable alternatives.

III. We note that the Administration's proposal calls for the imposition of a "special tax" on "electricity that an independent power producer provides to a utility under a fixed-price contract entered into before the date of enactment." Niagara Mohawk possesses a wealth of experience and expertise on the subject of independent power producers (IPPs). By 1995, we expect that 30 percent of our generation load and 70 percent of our fuel and purchased power costs will emanate from IPPs.

This special tax treatment is unnecessary. Fixed price contracts generally include a significant margin to absorb such unanticipated increases. If the margins were too narrow, few if any projects would ever survive. In drafting the contract, future costs can never be perfectly predicted. These uncertainties were negotiated risks that were accepted by the IPPs. However, in the interests of fairness, Congress could delegate to State Commissions the authority to pass through the cost on fixed price contracts under a showing of distress. We would be pleased to provide draft statutory language granting such authority.

Likewise, most of the IPPs who contract with Niagara Mohawk have fixed price gas contracts, so they would face no increase in their gas costs. Rather, the gas producers would bear the Btu tax increase. In many cases, the fixed price gas contracts are quite high given current market conditions, and well able to absorb the Btu tax. Again, we would suggest that setting the Btu tax at the source, and allowing State Commissions to determine the appropriateness of allowing a pass through is the best approach to address this issue.

Since the proposal speaks only to "fixed price" contracts entered into prior to the date of enactment, we assume that the "special tax" would not apply to contracts based on the avoided cost figures in our approved tariff. Although these contracts have no express tax pass through provisions, a fuel tax that raised Niagara Mohawk's avoided costs would be reflected in a higher rate, effectively compensating these IPPs. If these IPPs also got an exemption from the Btu tax, they could actually experience a windfall gain, granting them an unfairly privileged competitive position.

Furthermore, we have a large number of contracts with a fixed price schedule for a certain number of years and a reconciliation method that increases or reduces rates in the later years of the contract so that our average rate equals our avoided costs. Under these contracts, for each kWh over the contractual period sold at a fixed price in the early years, the difference between the fixed price and avoided cost is credited or debited to an "adjustment account" which is then collected or repaid in the later years of the contract. Under these contracts, a Btu tax would not increase the IPPs' present rates for electric power, but would reduce their ultimate refund obligations. Because we now anticipate that IPP refund obligations under these contracts will substantially exceed the value of their projects when the refund obligations begin, we are concerned that the operators of many of these projects will simply abandon their facilities when these refund obligations begin. Thus, State Commissions should be given the authority to pass on costs on a showing of distress (intended to minimize customer bill impacts).

Despite the foregoing comments (intended to minimize customer bill impacts), Niagara Mohawk does understand the Administration's desire to have the tax borne by the ultimate consumer. If that is a given, then it should be recognized that the utility industry is becoming increasingly competitive, and that a level playing field should be an important element of the legislation. Thus, Investor Owned Utilities that sell wholesale power should be given the same treatment as IPPs, and IPPs that sell power at retail be given the same responsibilities as a utility.

IV. We are very concerned about the floor stock provisions. As currently proposed, this portion of the tax could cost Niagara Mohawk over $8 million in the first year alone ($5.5 million for stored oil and $2.6 million for stored coal).

We understand and applaud the Administration's desire to make this tax as fair as possible. As I noted we have considerable expertise in this area and would be happy to make our experts available to assist in crafting appropriate provisions.

Sincerely,

Douglas R. McCuen

c: Senator Daniel Patrick Moynihan
Representative Michael R. McNulty
Representative Amory Houghton, Jr.

*** Niagara Mohawk is an electric and natural gas, investor-owned utility. The company provides electric service to 1.5 million customers across 24,000 square miles, and natural gas service to 493,000 customers in areas totaling 4,500 square miles in central, northern and eastern New York State. Niagara Mohawk generates 708 megawatts, approximately 9% of its total generation mix, from its 74 individual hydroelectric plants. The company also purchases substantial amounts of hydro from the New York Power Authority.

Pitney Bowes

Chairman of the Board
and President

April 1, 1993

The Honorable Dan Rostenkowski
United States House of Representatives
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski:

As an employer of nearly 24,000 in the United States, Pitney Bowes would like to express its concerns regarding President Clinton's deficit reduction package, which includes various proposals to increase corporate taxes. Several of these proposals are counter-productive to their desired outcomes of economic stimulation and job creation.

Corporate Tax Rate Increase

The President's proposed two-percent increase in the corporate tax rate will severely penalize U.S.-based publicly held companies. The performance of such companies, evaluated based on earnings per share (EPS), must be continually improved in order to meet shareholder expectations. Even a small reduction in EPS can significantly depress a company's stock price and ability to compete globally.

Because a two-percent tax increase would result in a significantly higher tax charged against current-year earnings, it would result in an immediate and substantial decrease in EPS performance. To mitigate the impact of the higher corporate tax rate, publicly held companies will be forced to reduce all controllable expenditures including employee headcount, workforce training, research and development, and investment in new equipment.

Instead of increasing corporate tax rates, one option would be to not enact into law the proposed temporary investment tax incentive for large business. From Pitney Bowes' perspective, in light of a corporate tax rate increase, the proposed investment tax credit would not provide sufficient economic incentive to increase spending on equipment. In fact, to offset the negative impact on earnings of a corporate rate increase, Pitney Bowes would be forced to reduce its investment in new equipment.

Royalties Sourced as Passive Income

President Clinton's deficit reduction package contains a proposal which includes royalties in a separate passive basket for foreign tax credit purposes. We urge the President and Congress to not make piecemeal changes to U.S. international tax policy. Instead, the foreign tax credit system should be reviewed comprehensively in the context of

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international tax reform. In order for the United States to regain its economic strength and viability, it must be able to compete in a global economy. Our current tax system places American companies at a disadvantage compared to their foreign competitors, and comprehensive changes to the system should be made to eliminate these competitive disadvantages.

The current U.S. foreign tax credit system exposes U.S.-based multi-nationals to double taxation of their foreign earnings by requiring companies to allocate and apportion U.S.-incurred expenses to foreign source income. As a result, U.S. companies receive a smaller foreign tax credit, and are thereby in effect denied a portion of their deductions for interest, salaries, taxes, accounting and other expenses. This restricts the ability of U.S. businesses to compete globally with foreign-based multi-nationals, and discourages U.S.-based companies from repatriating foreign-source income to the U.S.

The current treatment of royalty income is one of the few adjustments in the foreign tax credit system which helps U.S. companies offset these harsh and unfair expense allocation rules. This treatment enables U.S. companies to bring foreign-source income back to the U.S. while minimizing double-taxation of these funds.

The President's proposal, if implemented, will make it more difficult for companies to repatriate foreign-source income without double taxation. This will even further discourage companies from repatriating funds which are currently invested outside of the U.S.

The government should instead make it easier for companies to repatriate these funds, which would be used to invest in jobs, training and technology here in the U.S. We feel that companies should be permitted to place all foreign dividends in a separate basket to which no expenses would be allocated. This would permit U.S.-based companies to repatriate foreign earnings without exposing them to double taxation.

Other Proposals

We strongly support proposals which would permanently extend the R&D tax credit and which would allocate 100 percent of U.S. R&D expenditures to U.S.-source income. Both of these proposals will help provide increased incentives for conducting R&D in the United States.

Thank you for your consideration of our concerns.

Sincerely,

George B. Harvey

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PSA

Statement of the Public Securities Association

Before the House Committee on Ways and Means

Hearing on President Clinton's Proposals for Public Investment and Deficit Reduction

April 1, 1993

The Public Securities Association (PSA) is pleased to submit this statement on the President's comprehensive 1993 tax proposal. PSA is the international trade organization of banks and securities firms that underwrite and trade municipal securities, U.S. Government and agency securities, mortgage-backed securities and money-market instruments. PSA's membership accounts for approximately 95 percent of the nation's municipal bond market activity.

PSA supports President Clinton's efforts to achieve real deficit reduction and shift national priorities toward long-term investment and away from short-term consumption. Representing broker-dealers in the bond markets, PSA believes that deficit reduction is an important policy goal that is consistent with reducing long-term interest rates and freeing up capital for productive investment. PSA is also pleased that as part of his investment initiative, President Clinton placed emphasis on the use of municipal bonds as an efficient tool to achieve many of his policy objectives. We commend the Clinton Administration on its deficit reduction and public investment efforts, and we commend Chairman Rostenkowski and other members of the Committee for your legislative leadership and for your quick attention to the vital issues raised by the President.

The reaction of "the bond markets" to the President's plan has generally been very positive. The fixed-income markets began a sustained rally late last year. Clearly, many market participants believe that the debate in Washington over lower federal deficits may result in significant legislative action. The Administration's proposal represents a meaningful attempt to address the federal budget deficit. This Committee has heard and will continue to hear testimony from a wide group of public- and private-sector witnesses on many aspects of the Clinton plan. Rather than comment on the plan as a whole, this statement will focus on the tax provisions in the proposal directly related to PSA's markets.

The Role of Tax-exempt Municipal Bonds

State and local governments regularly issue debt securities — collectively known as municipal bonds — to finance public investment. Their ability to independently issue municipal bonds is one of the most powerful financing tools available to states and localities. Municipal bonds have many important features. First, bonds allow state and local governments to pay for big-ticket projects over time as they are used. Second, because states and localities can issue bonds without any direct federal approval, decision-making for individual projects can be concentrated at the local level, where the needs and priorities of states and communities are best known. Third, the market mechanism associated with municipal bond issues ensures that only creditworthy projects get financed. After all, it is ultimately investors in municipal bonds who decide whether projects are financially sustainable.

The most important feature of municipal bonds, however, is that interest paid to investors by state and local governments is exempt from federal taxation. Because investors who buy municipal securities know that their interest income will not be taxed by the federal government, they are willing to accept a lower yield on their investments. The tax-exemption reduces the interest rates paid by states and localities and permits issuers to finance projects more cost-effectively. The foregone federal revenue associated with tax-exemption represents a form of federal assistance for state and local governments. Because the amount of financing that results from tax-exemption exceeds the amount of foregone federal revenue associated with tax-exemption, municipal bonds permit federal policy-makers to leverage the federal contribution to state and local public investment.

In 1992, states and localities issued over $235 billion in tax-exempt bonds, much of which was used to finance or refinance public works investment. Municipal bonds are issued to finance a wide variety of public projects, including, but not limited to, roads, bridges, highways, schools, public buildings, water and sewer systems, solid waste disposal facilities, airports, low- and moderate-income housing and economic development.

President Clinton's Economic Plan

President Clinton's tax proposals being considered by the Committee recognize the important role municipal bonds can play in providing an efficient financing tool for targeted policy objectives. A number of the President's proposals, outlined below, would expand the ability of states and localities to use municipal bonds to finance public investment. PSA strongly supports the following proposals and urges their quick enactment.

Mortgage-revenue Bonds — The President has proposed that the Tax Code provision permitting states and localities to issue tax-exempt mortgage-revenue bonds (MRBs) be made permanent. The MRB provision expired on June 30, 1992, and since that time, state and local governments have been unable to issue tax-exempt mortgage bonds. Before June 30, 1992, MRBs were one of several "expiring tax provisions" which lapsed periodically and were renewed. MRBs allow states and localities to offer below-market-rate home mortgage loans to low- and moderate-income families. The program is targeted to prevent the use of MRB-financed mortgages by homebuyers who do not meet certain income restrictions or for homes that do not meet certain price restrictions. MRBs represent an efficient, cost-effective source of assistance for families that might not otherwise be able afford home-ownership.

Small-issue Industrial Development Bonds — The President has also proposed the permanent extension of the provision permitting tax-exempt small-issue industrial development bonds (IDBs), another of the "expiring provisions" which lapsed on June 30, 1992. IDBs permit state and local governments to issue tax-exempt bonds on behalf of small manufacturing firms and first-time farmers. The program is very targeted. The size of bond issues is limited to $1 million, and the use of bond proceeds is limited to manufacturing facilities and first-time farmers. IDBs are a popular and low-cost source of financing for targeted economic sectors.

Low-income Housing Tax Credit — The President has also proposed making the low-income housing tax credit permanent. Another of the "expiring provisions" that lapsed in June 1992, the tax-credit allows states and localities to attract private investment capital to rental housing development for low-income families. The tax credit can be used to some extent in conjunction with low-cost tax-exempt financing.

Enterprise Zones — The details of the President's enterprise zone proposal have not yet been released. However, indications from last year's enterprise zone bill (H.R. 11) and from the broad outline of the enterprise zone proposal contained in "A Vision of Change for America," it appears that the President's proposal will contain a significant tax-exempt bond component. Tax-exempt financing for enterprise zone firms would give states and localities an important tool to attract business to blighted areas. Particularly encouraging is the statement in "A Vision of Change" implying that the President's proposal would permit tax-exempt financing not just for enterprise zones, but for areas that would qualify as enterprise zones but are not so designated.

High-speed Rail — The President's proposal would permit tax-exempt financing for high-speed rail facilities outside of restrictive state volume caps. The current-law volume

cap restriction on tax-exempt financing for high-speed rail facilities is one of the principal impediments to the implementation of high-speed rail technology.

Additional Proposals to Encourage Public Investment

As creative as the above provisions are in using tax-exempt finance to encourage and assist state and local government investment, several other modest, responsible and cost-effective proposals, totally consistent with policies espoused in the President's plan, would allow for even greater levels of public investment. These proposals would leverage the federal financial contribution to such investment by reducing the interest cost for targeted state and local borrowing. All of these proposals have strong political support, and several of them have already been passed by Congress.

Proposals already passed by Congress:

Bank Investment in Municipal Securities — Over the past six years, the tax-exempt municipal bond market has become increasingly — and dangerously — dependent on individual investors as a source of demand, largely as a result of provisions contained in the Tax Reform Act of 1986. The most important result of that Act has been the complete loss of commercial bank demand for most municipals. Banks now participate only in the market for bonds issued by very small communities that sell $10 million or less per year. Raising the annual limit to $25 million would extend the benefits of bank demand to a broader group of small communities. A similar proposal was included in H.R. 11, passed last year by the 102nd Congress but vetoed by President Bush.

In addition to limiting permitted uses for tax-exempt bonds, the Tax Reform Act of 1986 (TRA) also influenced municipal finance by shifting the incentives facing potential investors in bonds. The most immediate effect of the TRA with respect to demand involved commercial banks. Prior to the TRA, commercial banks were allowed to deduct 80 percent of their interest costs associated with holding tax-exempt bonds. The bottom-line earnings attributes of municipal bonds made them an efficient tool for bank asset management. Accordingly, banks were active players in the bond market. By the end of 1985, banks held $231 billion worth of all municipal bonds outstanding, or 35 percent.

The TRA, however, eliminated the ability of banks to deduct interest costs associated with carrying tax-exempt securities for all but a small class of municipal bonds. Congress took this action to ensure that commercial banks could not eliminate their income tax liability. PSA does not quarrel with the underlying premise of this policy goal. Rather, we are concerned about the impact that loss of bank deductibility has had on the composition of demand for municipal bonds, and by extension, what these demand changes portend for the future cost of borrowing for state and local issuers.

As a result of the changes in the 1986 Act, banks have steadily reduced their holdings of bonds. As of the end of 1992, banks held less than $98 billion worth of bonds, amounting to a reduction of $133 billion since 1985. Consequently, commercial banks (as a group) no longer support the bond market, but weaken it, since by selling bonds they add more supply to the market. In fact, banks undoubtedly would be selling at a greater rate but for the fact that their holdings in 1986 were grandfathered from the loss of bank deductibility.

Although it is difficult to quantify precisely, the loss of bank demand has certainly kept municipal yields higher than they otherwise would have been. One can get an idea of the importance of bank demand by examining the one sector of bonds that banks are allowed to purchase with deductibility. In 1986, Congress decided to support the market for bonds issued by small cities and towns by allowing banks to deduct 80 percent of the cost of carrying public purpose[1] (non-private activity) bonds issued by communities that issue $10 million or less in such bonds annually. Congressional policy goals have been served well by this provision. Although disinvesting in the municipal market as a whole,

[1] The Internal Revenue Code distinguishes between bonds issued for purely public uses and bonds issues for projects with a significant element of private participation. The Code defines "private-activity" bonds as issues where ten percent or more of the bond proceeds are used by a private entity and ten percent or more of the debt service is secured by a private entity. In general, private-activity bonds cannot be tax-exempt. However, tax-exempt private-activity bonds are permitted for certain specific types of projects and facilities, subject to volume caps and other restrictions.

banks have remained active in the market for bonds issued by small communities (so-called "bank qualified" bonds).

Communities that qualify as issuers of bank-qualified bonds enjoy a yield advantage over similar communities that do not qualify. This advantage varies widely depending on market forces, but is currently somewhere in the neighborhood of 20 to 30 basis points (0.20 to 0.30 percentage points) and has been as high as 40 basis points in 1992. In other words, small issuers are able to finance their public needs more economically because the "bank-qualified" provision stimulates bank investment. In 1989 approximately $11.5 billion in bank-qualified securities were issued, resulting in an interest cost savings of between $173 million and $228 million for those issuers over the lives of their issues.

PSA recommends raising the annual issuance limit for bank qualified bonds from $10 million to $25 million. Raising the limit would extend the interest rate benefit of bank deductibility to a wider group of small communities and would provide current small issuers with greater latitude in planning their financing activities.

Tax Simplification — Among the tax simplification provisions contained in the two tax bills passed last year by Congress are proposals to simplify some of the more complicated and restrictive Tax Code provisions related to tax-exempt bond issuance. Some of these proposals are targeted at small issuers, who have a particularly difficult time accessing the capital markets. The two most important provisions would raise the small-issuer arbitrage exemption from $5 million to $10 million and would eliminate the five-percent unrelated and disproportionate use rule. All of the simplification proposals are relatively non-controversial, and grew out of the recommendations of the Anthony Commission on Public Finance. Many of the provisions are included in a simplification bill introduced by Chairman Rostenkowski, H.R. 13, earlier this year Other bond simplification provisions passed by Congress last year in H.R. 11 include:

- Simplification of the six-month spend-down arbitrage rebate exemption.
- Simplification of compliance with 24-month arbitrage rebate exception for construction bonds.
- Provision providing that the simultaneous issuance of certain discreet issues would not be aggregated if one of the issues is a tax revenue anticipation note (TRAN).
- Repeal of the 150-percent of debt service limit for investment of proceeds from private-activity bond issues.
- Clarification of definition of “investment-type property” for the purposes of arbitrage restriction and rebate.
- Authority for the Treasury Department to exempt certain taxpayers from tax-exempt interest reporting requirements.
- Provision permitting tax-exempt financing for United Nations facilities.

Bonds Issued by Tax-exempt Institutions — Tax-exempt 501(c)(3) organizations are permitted to issue tax-exempt bonds. However, the Tax Code prohibits non-hospital 501(c)(3)s from having more than $150 million of bonds outstanding at one time. The Code also classifies 501(c)(3) bonds generally as private-activity bonds, and hence imposes on them certain restrictions that are not applicable to governmental municipal bonds. The limitations on 501(c)(3) bonds, and especially the $150 million outstanding provision, have been particularly restrictive for private, non-profit colleges and universities, who are heavily capital-dependent, especially with regard to research facilities. H.R. 11 would have lifted the $150 million cap and would have provided that 501(c)(3) bonds generally be treated as governmental bonds, rather than private-activity bonds.

Additional modest proposals consistent with the policy of the President's economic program:

State Bond Volume Caps — So-called private-activity tax-exempt bonds, which include MRBs and IDBs as well as bonds issued to finance various environmental infrastructure facilities and low-income housing projects, among other uses, are collectively subject to

state private-activity bond volume caps. It is necessary for project developers to compete with each other for cap allocation in order to obtain tax-exempt financing. Moreover, since the current cap was imposed in 1986, its amount has never been indexed for inflation. Many worthwhile projects never get financed because of volume cap limitations. The problem is particularly acute in large, populous states.

The Tax Reform Act of 1986 imposed a number of limitations on the issuance of tax-exempt bonds by states and localities. One of these limitations, known as the unified volume cap, restricted the annual volume of so-called "private-activity" bonds that can be issued by each state. Among the projects financed under the cap are mortgage-revenue bonds (MRBs), small-issue industrial development bonds (IDBs), and a variety of infrastructure projects involving public-private partnerships. In 1986, the cap was set at the greater of $75 *per capita* or $250 million per state. Beginning in 1988, the cap was lowered to the greater of $50 *per capita* or $150 million. In recent years, a number of states have begun to exhaust their annual volume caps and have been forced to postpone or cancel investment projects involving private activity because tax-exempt financing could not be secured.

Since 1988, inflation has eroded the value of states' volume caps. In real terms, the value of volume caps actually decreases each year. In constant 1988 dollars, the current cap is about $41.25 *per capita* or $120.8 million, not $50 *per capita* or $150 million. Without any conscious federal policy decision, the value of state volume caps has fallen by nearly 20 percent in just five years. Under current law, inflation will continue to erode their value, and fewer and fewer projects will be able to be financed.

The original decision by Congress in 1986 to reduce the cap beginning in 1988 was based on the assumption that states' authority to issue MRBs and IDBs would expire at the end of 1987. In fact, those programs have been extended several times since then, but the volume cap has not been restored to its 1987 level.

The erosion of states' abilities to issue private-activity bonds has caused a number of states to exhaust their cap. In 1991, the last year for which complete data is available, private-activity issuance in 13 states totaled at least 90 percent of volume cap. In 37 states, private-activity issuance plus allocated volume that makes up the carryforward allowance[2] totaled at least 90 percent of the cap. In 41 states, the volume cap was exhausted completely, with issuance plus carryforward totaling 100 percent of the cap.

Limitations on bond issuance caused by volume caps could potentially frustrate the Administration's policy efforts where tax-exempt bonds are employed. For example, MRBs and IDBs — the authority for which would be extended in the President's plan — require volume cap allocation. Enterprise zone bonds, too, presumably would require cap allocation before they could be issued.

There are several options that Congress and the Administration could undertake to address the issue of volume caps. The most targeted approach would be to permit certain types of projects to be financed with tax-exempt securities outside of state volume caps. Many categories of projects, such as solid and hazardous waste disposal projects, wastewater treatment and collection facilities, community development and certain multifamily rental housing projects, and transportation facilities, represent essentially public uses of tax-exempt securities regardless of whether states or localities solicit private participation in providing the associated services. The most widely discussed means of legislating such a change is to define in the Tax Code a new classification of tax-exempt securities known as "public-activity" bonds, which would encompass the above uses of proceeds. In general, public-activity bonds could be issued without restriction regardless of the level of private participation as their underlying benefit would be directed to the public at large. PSA recommends such an approach in exempting public uses of private-activity bonds from state-wide volume caps. At the very least, the volume caps should be indexed for inflation to ensure the borrowing capacities of states do not erode over time.

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[2]If states do not use their entire cap in a given year, they may designate the remaining cap authority for specific uses in future years. This so-called carryforward allowance must be used within three years. It is important to consider carryforward allowance when examining volume cap usage because many states, knowing that planned future projects will require substantial cap allocation, reserve cap allocation as carryforward to be combined with annual volume cap in future years.

Alternative Minimum Tax — All tax-exempt bonds are subject in some way to the corporate AMT. In addition, so-called private-activity bonds are subject to the individual AMT. The corporate AMT inhibits corporate investment in tax-exempt securities, especially by commercial banks and property and casualty insurance companies, the only remaining substantial sources of corporate demand for municipals. Reducing the effect of the AMT on municipals — by eliminating the application of the individual AMT to private-activity interest and by reducing the application of the corporate AMT to public-purpose bonds to its pre-1990 level of 50 percent of interest earned instead of the current 75 percent — would expand the corporate base of demand for municipals and would make it easier for states and localities to sell their securities. It is likely that this proposal would have a negligible revenue effect for the Treasury, since firms and individuals now subject to the AMT simply avoid purchasing bonds that pay AMT interest.

The alternative minimum tax (AMT) was set in place by the Tax Reform Act of 1986. The purpose of the tax is to ensure that all taxpayers pay a minimum level of income or corporate tax regardless of exemptions, deductions or other tax preferences. Because of its structure, the AMT has greatly decreased demand for municipal bonds. PSA objects not to the underlying purpose of the AMT, but to its means of implementation: the taxation of supposedly tax-exempt municipal bonds.

The AMT applies to otherwise tax-exempt interest in two ways. First, all of the interest on tax-exempt private-activity bonds, *i.e.*, bonds issued by states and localities for the benefit of private parties, is subject to both individual and corporate AMTs. As a result, yields on these AMT bonds are currently between 25 and 30 basis points (0.25 to 0.30 percentage points) higher than yields on other, similar bonds. The higher cost to the issuer of AMT bonds does not necessarily correspond with substantial revenue gains to the Federal government. Investors subject to the AMT simply avoid such bonds, and they are instead purchased by investors not exposed to the AMT who enjoy a higher tax-free yield.

In addition to subjecting the interest on private-activity bonds to the AMT, the 1986 Act also subjected a portion of interest on public purpose tax-exempt bonds and on tax-exempt bonds issued on behalf of tax-exempt 501(c)(3) organizations to the corporate AMT. Until 1990, 50 percent of the interest on public purpose and 501(c)(3) bonds was subject to the AMT. Beginning on January 1, 1990, 75 percent of the interest on these bonds is subject to the AMT. Since the corporate AMT is 20 percent, this means that corporations affected by the AMT effectively pay a tax rate of 15 percent on tax-exempt interest on public purpose and 501(c)(3) bonds.

The application of the corporate AMT to public purpose bonds, and the increase in the percentage of interest taxed, have had a deleterious effect on demand from property and casualty insurance companies (P&Cs), now the major corporate investors in municipal bonds. Since 1986, P&C purchases have helped temporarily mask the impact of bank disinvestment in municipal bonds. Recently, however, P&C municipal bond purchases have dropped in response to the alternative minimum tax. Property and casualty insurance companies were net sellers of bonds in 1992. Commercial banks, which remain the dominant investors in the bank-qualified market, are also negatively affected by the alternative minimum tax. Interest cost deductibility and the AMT are closely interrelated. Banks that would otherwise purchase bank-qualified bonds have been driven from the market by the increase in the AMT that took place at the beginning of 1990.

The corporate AMT has increased borrowing costs for many state and local governments. Moreover, when combined with the loss of bank deductibility for municipal bond portfolios, the AMT threatens to hurt the borrowing ability of small communities especially. The percentage of interest taxed on public-purpose bonds should be lowered to the pre-1990 level of 50 percent. This would broaden the capacity of corporate entities to invest in public projects while still preserving the underlying goal of the AMT. Moreover, the application of the individual AMT to municipal interest should be eliminated as it results solely in increased borrowing costs to public entities, an investment windfall to non-AMT payers, and little or no federal tax revenue.

Advance Refundings — Current law restricts the number of so-called "advance refundings" permitted for a tax-exempt bond issue. Advance refundings occur when issuers refinance bond offerings to take advantage of lower market interest rates before the original bonds mature or are callable. Public purpose bonds issued before 1986 are

permitted to be advance refunded twice. Public purpose bonds issued since 1986 can be advance refunded only once. Private-activity bonds cannot be advance refunded. Restrictions on advance refundings have prohibited many states and localities from taking advantage of current historic low market interest rates by refinancing outstanding debt. Removing the restriction would result in significant cost savings for states and localities, thereby freeing up capital for more investment and job creation.

Political Support

Expanding the use of tax-exempt financing to assist and encourage greater levels of public investment has the strong endorsement of many members of Congress and of state and local officials across the country. In addition, the following groups have expressed support for tax-exempt bonds in general, and have all endorsed specific provisions to expand the market.

Rebuild America — Rebuild America is a coalition of public and private groups organized to promote more and better investment in America's infrastructure. Its current Chairman is Atlanta Mayor Maynard Jackson. Rebuild America's legislative agenda includes several proposals related to tax-exempt finance.

The Commission to Promote Investment in America's Infrastructure — A creation of 1991's Intermodal Surface Transportation Enhancement Act (ISTEA), the Infrastructure Investment Commission is composed of public and private officials. The Commission was created to investigate ways to improve infrastructure finance. Among the several recommendations contained in its recent report are proposals to improve tax-exempt financing of infrastructure.

The Anthony Commission on Public Finance — Created by former Congressman Beryl Anthony (D-AR), the Anthony Commission on Public Finance is composed of public and private tax-exempt bond market participants. The Commission was formed to study the market and suggest improvements. In 1989, the Commission issued a report containing a number of findings and recommendations. As Governor of Arkansas, President Clinton was a member of the Anthony Commission and endorsed its report.

Public Finance Network — The Public Finance Network is coalition of public interest groups representing state and local public officials dedicated to improving the municipal bond market.

Summary

President Clinton's economic program represents an important federal policy shift towards encouraging and assisting in greater levels of public and private investment. The program would also result in meaningful federal budget deficit reduction. For these reasons, PSA commends the Clinton Administration for its efforts. We are particularly pleased that the Administration has recognized the important role that tax-exempt municipal bonds can play in providing financing for the President's policy goals and encouraging partnerships among federal, state and local governments and the private-sector. As important as the President's proposals are, however, they do not fully tap the financing capacity of the municipal market. We urge the Committee in its debate over the President's plan to adopt the provisions outlined above. They are consistent with the goals of the President's proposal, and they would result in even greater levels of public investment for continued economic growth.

rpa
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**STATEMENT OF THE
RENAL PHYSICIANS ASSOCIATION
TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
FOR THE RECORD OF THE HEARING
MARCH 10, 1993**

**RE: PRESIDENT CLINTON'S PROPOSALS FOR
PUBLIC INVESTMENT AND DEFICIT REDUCTION
AS THEY RELATE TO
MEDICARE PART B AND END-STAGE RENAL DISEASE (ESRD) SERVICES**

The Renal Physicians Association (RPA) is taking this opportunity to provide a statement to the House Ways and Means Committee for the record of the March 10, 1993 hearing on President Clinton's proposals for public investment and deficit reduction.

RPA is the professional organization of nephrologists whose goals are to insure optimal care under the highest standards of medical practice for patients with renal disease and related disorders. RPA acts as the national representative for physicians engaged in the study and management of patients with renal disease.

Our comments will focus on the President's proposals which affect Medicare Part B and End-Stage Renal Disease (ESRD) services.

Health Care Reform and Consideration of Benefits for Inclusion in a Standard Health Benefit Package

As you are well aware, the President's Health Task Force chaired by Hillary Rodham Clinton is in the process of developing a standard benefit package for all Americans. With health care reform closer now than ever, the RPA is very concerned that the standard (basic or comprehensive) benefit package offered in any health care reform proposal specifically include all medically necessary renal related services including dialysis and renal transplantation.

The Medicare End-Stage Renal Disease (ESRD) program covers almost 93 percent of ESRD patients or approximately 150,000 individuals. While this program should remain intact as part of health care reform[1], there are a growing number of individuals who are not eligible for the Medicare ESRD benefit but who need ESRD services[2]. We believe it is therefore necessary to cover these individuals under the standard package. RPA would urge this committee to ensure that all Americans are covered for medically necessary renal related services including renal dialysis and transplantation either through the Medicare ESRD program or through a standard benefit package that all health plans or employers would have to provide.

Payment Reduction for Erythropoietin (EPO)

Erythropoietin or EPO is a pharmaceutical used by patients suffering from kidney failure to counter anemia by increasing the body's production of red blood cells. EPO has allowed many dialysis

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[1] Although an assessment of the Medicare ESRD program within a new health care system should follow, the program could now serve as a model for health care reform. With prospective capitated payments for dialysis related physician services and treatments, the ESRD program is a model of cost effective managed care. In fact, according to HCFA's own data, per patient costs have decreased over time. This virtual single payer system (for a specific disease) has contained costs, expanded access to quality care and lengthened life expectancy.

[2] Kidney Failure and the Federal Government, Institute of Medicine (1991).

patients to return to work and/or to lead more normal and fuller lives. Nephrologists, dialysis facilities, hospitals, and patients all need to purchase this drug because of medical need in the various settings in which this drug is administered.

Under the President's proposal as well as HR 21, Medicare payments for EPO would be reduced from $11 to $10 per 1,000 units. While we understand that this payment reduction is directed at the drug's manufacturer, RPA is concerned that this reduction not be passed on to patients and providers in the form of higher prices. Individual nephrologists and dialysis facilities are not in a position to negotiate rates with the manufacturer or suppliers, let alone patients. We must pay whatever the drug company or supplier charges.

Medicare expects nephrologists and dialysis facilities to pay for EPO from capitated rates which are already in need of desperate updates (see related discussion below on the need to increase the composite rate). These are the Monthly Capitated Payment (MCP) rate paid to nephrologists for treating dialysis patients in the outpatient setting (the subject of another paper), and the Composite Rate paid to dialysis facilities for outpatient maintenance dialysis treatments and related services (see below). While nephrologists and dialysis facilities pay for EPO to administer to patients, some patients do also purchase the drug fully out of pocket for home administration.

The issue of drug pricing and its impact on access is a complicated one. The RPA cannot claim that this proposed reduction would impede access to EPO, but we would urge this Committee at the very least to direct HCFA to closely monitor and annually report on access to EPO if this reduction in the EPO rate is enacted.

Extending and Altering the Medicare Secondary Payor Provision for ESRD Beneficiaries

The President's proposal calls for permanently extending the Medicare Secondary Payer (MSP) provision for ESRD patients from 12 to 18 months. This extension would otherwise expire in January 1996. Last year's Medicare package as included in HR 11 would have extended this provision to 24 months through 1995 for ESRD patients. During these initial periods, employer provided group health plans are expected to serve as primary payer for ESRD related medical expenses before Medicare would kick in.

The President's proposal would also make uniform all the other MSP provisions which affect not only ESRD beneficiaries, but also the aged and disabled. The plan would make all employer thresholds consistent with the aged provision which is 20 or more employees. That is, all employers with 20 or more employees with a group health insurance plan would be required to act as primary payer for its aged, disabled, and Medicare ESRD entitled employees for specified amounts of time. This requires a reduction in the disability provision from 100 to 20 employees and the creation of a 20 or more employee threshold for ESRD beneficiaries. Currently, all employer health plans, regardless of the number of employees, are required to serve as primary payers for beneficiaries who have become entitled to Medicare solely because of ESRD (as opposed to becoming entitled because of age or disability).

Lastly, the President would also eliminate the exemption from the MSP provision for individuals with ESRD who are also aged or disabled. Payments for these individuals would be treated the same as with payment for beneficiaries entitled to Medicare solely because of ESRD.

A recent interim General Accounting Office (GAO) report[3] which studied the effects of the OBRA '90 ESRD MSP extension from 12 to 18 months, showed that the extension appeared to have negatively affected some beneficiaries' or their spouses' access to and retention of employment or employer health insurance. Although the numbers are relatively small this is cause for concern especially since the sample size was limited. A broader study should be conducted before Congress decides to make this extension permanent. In addition, the GAO's study of the effects of this provision is not completed. The GAO has yet to report on beneficiary out of pocket expenses and other issues, expected to be completed in January 1995.

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[3] Medicare: Millions in End-Stage Renal Disease Expenditures Shifted to Employer Health Plans, United States General Accounting Office Report to Congressional Committees (December 1992).

Since we do not know yet what President Clinton's health care reform proposal will look like, it is difficult to speculate on how this provision will affect ESRD patients under a new health care system. ESRD patient and spousal access to health insurance (and job discrimination) is an issue that should be analyzed within the context of the President's health reform plan.

Extending the Physician Ownership and Referral Ban

President Clinton's economic package would extend the current ban on Medicare physician ownership and referral to outside clinical laboratories to other services including: physical and occupational therapy; radiology and other diagnostics; radiation therapy; durable medical equipment, and parenteral/enteral nutrition equipment and supplies. There have been similar proposals by Congressman Stark and others to also extend the current ban.

RPA is fully supportive of efforts to eliminate unethical referral arrangements by physicians. Although the President's provision in this area does not include renal dialysis facilities, RPA would like to ensure that any bill passed by the Congress in this area exclude nephrologist owned renal dialysis facilities because **dialysis centers are an extension of the nephrologist's medical practice**. This is clearly recognized within the medical community. Unlike most referral facilities, dialysis provides a therapeutic service and is not used for diagnostic purposes. Dialysis facilities only serve patients with irreversible kidney failure who must receive dialysis to maintain their lives. Dialysis is not an elective procedure and its medical necessity cannot be questioned.

Legislation which would blanketly ban self referral arrangements by physicians should explicitly exclude renal dialysis facilities. The following legislative language is suggested by the RPA:

> Nonreferrals. The following shall not constitute a referral by a referring physician: a referral by a physician, or by a member of his or her group, to a renal dialysis provider in conjunction with a renal dialysis procedure performed under the supervision of the physician or by a member of his or her group.

Increasing the Composite Rate Paid to Dialysis Facilities

The Prospective Payment Assessment Commission (ProPAC) has recommended to Congress that the composite rate for dialysis facilities be updated by 2.5 percent for FY 1994. The RPA fully supports this long overdue update and urges Congress to enact this recommendation. As you may know, the composite rate paid to renal dialysis facilities for outpatient maintenance dialysis treatments and related services under Medicare has essentially been either frozen or reduced since the rate was established in 1973 with the exception of a $1 increase per dialysis treatment in 1991. Even with this $1 increase in 1991, the composite rate has dropped over 60 percent in real dollars because of explicit freezes and rate reductions and the unadjusted effects of inflation[4] since 1974.

It is true that there were some productivity increases in the 70s and part of the 80s which allowed many dialysis facilities to operate successfully with the established rate, but reports about jeopardizing quality of care under these real dollar decreasing rates, especially from such notable sources as the Institute of Medicine[5], is cause for alarm.

While there is not as much available and reliable data upon which to make a decision in this area as some would like, it is clear that some update is called for. A 2.5 percent increase in the composite rate as recommended by the ProPAC would at least provide in part for inflation and the extra costs associated with EPO, and the new regulatory burdens of CLIA, OSHA and ADA. With these extra costs and the fact that the rate has not been evaluated or updated in 20 years (with the exception of the $1 dollar per treatment increase in 1991), a 2.5 percent increase is modest in any terms.

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[4] See Kidney Failure and the Federal Government, Institute of Medicine (1991); and Committee on Ways and Means, U.S. House of Representatives, Background Material and Data on Programs Within the Jurisdiction of the Committee on Ways and Means (aka: the Green Book), (1992 Edition).

[5] Ibid.

RPA's concerns about the quality of patient care is number one on our agenda. We are involved in practice guidelines research and development and are working with the Agency for Health Care Policy and Research (AHCPR) and the National Institute of Diabetes, Digestive, and Kidney Diseases (NIDDK). Our efforts are also integrally connected with the U.S. Renal Disease Data System also known as the ESRD Patient Registry. A 2.5 percent update in the composite rate, as recommended by ProPAC, would certainly help renal dialysis facilities to maintain (and possibly improve) the quality of care provided to ESRD beneficiaries.

Reduction in the Medicare Volume Performance Standard and Update Default Formula

The purpose of the President's proposal in this area is to reduce the amount of increases in physician fees in future years. The plan would reduce the Medicare Volume Performance Standard (MVPS) default formula and the default update for Medicare payments to physicians.

RPA supports the need to amend the VPS formula established by Congress in OBRAs 89 and 90. Last year, the RPA urged Congress to preclude an almost four times higher and separate update for surgery than for non-surgery including primary care that would occur under the default formula. Unfortunately, Congress adjourned without taking any action to prevent this higher update for surgery from going into effect in 1993. The result is, unless Congress acts to correct the problem now, surgical services will permanently have a higher dollar conversion factor update than non-surgical services including primary care visits and other evaluation and management services.

The President's proposal provides an opportunity to correct this flaw. Instead of lowering the default VPS equally for all services, as the President's proposal would do, RPA would urge Congress to either support a single VPS for all services, or create a separate and higher VPS for EM services and a higher default update for primary care services including office, nursing home, and home visits.

The Physician Payment Review Commission, in its upcoming report to Congress will be recommending a similar approach. If separate VPSs are to be maintained says the PPRC, then EM services should be given improved treatment by being placed under their own VPS.

Exempting Primary Care From Any Reductions In Physician Fees In 1994

RPA fully supports the Administration's plan to exempt primary care from the reductions proposed for all other physician services. The President's proposal would reduce the current law Medicare conversion factor by two percent for all services except primary care. If these reductions are taken at the same time the Medicare update is provided based on the current MVPSs (which we understand is the Administration's intent), this proposal would in effect provide primary care with a full conversion factor update while reducing the amount of the update for all other services.

While RPA is pleased with the Administration's efforts to protect primary care, it must be noted that because primary care is lumped in with non-surgery in the current law VPS, surgery may still receive a higher update than primary care services even under this approach proposed by the President (see related discussion on the altering the default VPS and update above). Nevertheless, the President's proposal would represent the first time in three years that primary care has received an update equal to inflation. By contrast, the 1993 update for primary care services was only 0.8 percent, compared to 3.1 percent for surgery -- the exact opposite of what should have occurred to promote and encourage primary care.

The President's plan appears to recognize that if cuts in Medicare are required, they should not negatively impact on primary care services. RPA would urge Congress to uphold the President's approach by providing a full 1994 fee schedule update for primary care services, and to reject calls for an across the board reduction that will be presented under the guise of "fairness." Similarly, if Congress entertains the idea of delaying the update entirely for a period of six months, for example, keep in mind that such a delay continues to perpetuate the almost four times higher and separate update for surgery (than for non-surgery including primary care) that took place in 1993. In addition, if a delay in the update is sought (which is obviously not the preferred approach), it should be enacted only on the condition that primary care services receive the full update at the end of that period.

Resource-Based Practice Expenses for the Medicare Physician Fee Schedule

The Administration is proposing to begin phasing in a resource-based practice expense index for the Medicare Fee Schedule beginning in 1997. To cut the deficit, the proposal also calls for reductions in practice expense relative value for certain services in 1994, 1995, and 1996. According the President's plan, practice expense values would be reduced for services if the practice expense value exceeded the work value for a particular service.

RPA supports the idea of a fully resource based relative value scale. However, we are troubled by this proposal for several reasons. First,
the President's method to reduce practice expense values is completely arbitrary. Why would the fact of having a practice expense value greater than the work value suggest that the practice expense value is overvalued and should be reduced? Although this arbitrary method would move many practice expense values closer to where they would be under a resource-based practice expense index, some may be cut to deeply, and others may be cut entirely without cause or reason resulting in a skewed RBRVS.

Second, there is still research that needs to be done, data to be collected, and questions to be answered, before a decision on an appropriate methodology for a resource-based practice expense index can be made and implemented -- even the Physician Payment Review Commission and the Health Care Financing Administration would admit this. Third, RPA is concerned about disrupting the initial current phase in of the fee schedule which will not be completed until 1997.

Fourth, while we understand that physicians must do their share to contribute to reducing the federal budget deficit, we would feel somewhat betrayed if the RBRVS was used merely for budgetary reasons, disregarding its original intent: namely to redistribute payments away from overvalued procedures to undervalued services such as office visits. Office visits and other evaluation and management services have practice expense components which remain undervalued.

If Congress decides to pursue the President's plan in this area, then it would be wise to also devise a mechanism (equally arbitrary) whereby undervalued services including primary care would see increases in their practice expense values at the same time overvalued services received decreases. Otherwise, the RPA would recommend not to tinker with the RBRVS until such time as a sound methodology is developed and better data collected on resource based practice expenses. The PPRC believes that this will occur by 1997 and thus has recommended that resource-based practice expenses be implemented at that time.

rpa\ultwm/bjn

Dan Rostenkowski, Ill., Chairman

March 18, 1993

Senate Committee on Finance

House of Representatives Committee on Ways and Means

(Lists Attached)

Re: President Clinton's Energy Tax Proposal for Hydroelectric Power

Dear Legislators:

I am writing to you to request your help in rejecting, or at the very least, modifying the current revenue measure before you with respect to its proposed rules for hydroelectric generation. This is a clean source of electric power, which produces no greenhouse gases or toxic waste products. In fact, it is one of the oldest forms of renewable energy in the world.

I am asking you to endorse the recommendations of the National Hydropower Association, so that this country can continue to rely on a non-polluting energy source free from foreign interference. It is also an extremely efficient source of generation, with efficiencies in the 85% to 95% range. Compare this with any other energy technology and it beats most, if not all others.

Rochester Gas and Electric (RG&E) is in the final phases of relicensing our four main hydro plants before the Federal Energy Regulatory Commission. The economics of these stations are in danger of becoming marginal at best with this new added tax, and this could force their shutdown. RG&E will not operate uneconomic plants; this serves neither our ratepayers nor our shareholders. Our customers would then have to be supplied with other forms of generation, in the form of coal- or nuclear-powered electricity. In my opinion, this would not serve the long-term benefit, or enhance the environment, of the country.

I urge all of you to recognize, accept, and endorse the following positions with regard to hydroelectric generation:

1. Hydroelectric generation is a renewable resource, to be utilized for the public benefit; it is consistent with our National Energy Policy with respect to the environment; and it must be considered as renewable in future deliberations.

2. Exempt all hydropower projects under 5 MW capacity; these projects are competitive with and comparable to solar and wind projects. These are the "entrepreneurial" projects, which provide clean power for small operators, and help offset the need for large, centralized plants. The tax, in its present form, would render these projects uneconomical, as the taxes imposed would exceed the revenues gained.

3. Exempt energy generated by pumped storage projects; these would be subject to double taxation under the current proposal. It doesn't make sense to charge what is essentially a heat tax to plants that produce no heat.

4. At the very least, lower the conversion rate for hydropower to account for its high rates of efficiency. This rate is now at 10,315 BTU/kwh, which is reflective of the heat rate for a coal-fired plant. Given the higher generating efficiencies of hydro stations, they should be rated at 3,700 BTU/kwh. This figure more fairly represents the plants' efficiency.

The current BTU tax structure does not account for hydropower's high efficiency. Taxing these plants at a rate equivalent to that for coal plants is neither good policy nor makes economic sense. This is the number one source of renewable energy in the nation today; failure to revise the proposed tax will only result in higher rates for our customers in Western New York, and a more uncertain environment for all in the future.

Hydropower is compatible with the environment, is used for the public welfare, and is the most efficient form of large-scale electrical generation today. With all the benefits to the people of our country, I urge each and every one of you to work to revise this unfair tax.

Yours truly,

David K. Fingado

David K. Fingado
Licensing Coordinator

nha7

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T. Swartz
Relicensing file

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March 29, 1993

Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

ATTENTION JANICE MAYS

Dear Mr. Rostenkowski:

On behalf of the State Teachers Retirement Board of Ohio and the more than 270,000 active and retired teachers in Ohio, I appreciate the opportunity to submit a written statement to the House Committee on Ways and Means concerning the hearings on the Administration's public investment and deficit reduction proposals.

Our interest is focused on investment proposals which could include public pension funds. Because of your long involvement and experience on these issues, as well as being from Illinois, which has several non-Social Security public pension systems, I am confident that you understand the concerns of my state, Ohio. Here, all of the state's public pension systems are also non-Social Security.

Mature pension funds such as STRS, which had its beginning in 1920, are increasingly dependent on investment income to meet future benefit obligations. Currently, investment income makes up more than 60 percent of our financial base and that percentage will rapidly grow.

Simply stated, any federal proposals designed to attract public funds for investment purposes should meet the following criteria:

1. Pension fund investments should be invited, not mandated or coerced.
2. A government credit enhancement or guarantee of the loans would help sell the plan.
3. The rates paid investors must be competitive with market rates.
4. Pooled arrangements would be preferred to riskier types of projects.
5. The investments will be much more attractive if they are structured to be readily marketable to other investors besides pension funds.

These features are not unique to the needs of public pension funds. They apply to sound investment strategies for whomever might become involved. To be successful, any proposed plan must offer competitive returns with understandable and acceptable levels of risk.

I hope this information is helpful in presenting the conceptual framework we believe must be contained in any proposal to attract public pension fund investment. Again, I appreciate the opportunity to comment.

Respectfully,

Herbert L. Dyer

Herbert L. Dyer
Executive Director

HLD/l

STATEMENT OF THE SYNTHETIC ORGANIC CHEMICAL MANUFACTURERS ASSOCIATION BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES MARCH 29, 1993

The Synthetic Organic Chemical Manufacturers Association (SOCMA) is grateful for this opportunity to present its views on President Clinton's investment and deficit reduction plan.

SOCMA is a trade association serving more than 225 companies that have a common interest in the manufacture, distribution and marketing of synthetic organic chemical products. SOCMA member companies are representative of a much larger number of organic chemical manufacturers throughout the United States. The synthetic organic industry is diverse, with some plants producing large volumes of a few chemicals and others producing small volumes of a large variety of specialty chemicals. Small volume production of specialty chemicals is generally performed by batch processes versus continuous processes. The majority of SOCMA's members are small businesses with annual sales under $40 million.

SOCMA supports President Clinton's effort to reduce the federal deficit. SOCMA supports a budget plan that will help build our nation's economic future. SOCMA believes that additional cuts in government spending beyond those proposed by the President should be made which would reduce the need for more revenues. However, if the Congress seeks new revenues, the essential question is "how can additional revenues best be raised without damage to the economy and adversely affecting our international competitiveness?"

SOCMA believes the best revenue raising alternative is adoption of the same credit method value-added tax that is already utilized by virtually all of our major competitor nations.

There are advantages to adoption of a value-added tax as an alternative to other new taxes including:

(a) A value-added tax is a fair tax.

(b) Adjustments can be made to make it progressive.

(c) It can be a major revenue source.

(d) It is trade neutral.

(e) It will not jeopardize the jobs of American workers.

SOCMA believes that a BTU tax and other taxes that would disadvantage U.S.-based production competing against foreign-based production is poor economic policy.

Two provisions of the President's plan will add significantly to the costs of, and will discourage investment in, U.S.-based manufacturing:

- The proposed BTU tax would add significantly to the costs of manufacturing in the United States--over $5 billion annually to manufacturing as a whole, $1.2 billion of that to chemicals manufacturing costs alone.

- The rise in the corporate income tax rate will lower the rate of return on investment and incentives to invest, particularly investments by manufacturing companies, like our members, that must face international competition.

Higher costs from energy taxes translate to higher prices to consumers, lower wages to employees, U.S. jobs lost to foreign competitors, and lower profits. In turn, lower profits lead to reduced investment and to lower productivity and lower U.S. living standards than would otherwise be achieved.

SOCMA believes that, in a highly competitive world economy, it is poor public policy to further tax our own U.S.-based manufacturing production. If Congress decides additional tax revenues are required, the interests of all Americans are best served by taxes levied on consumption--not by taxes on U.S.-based manufacturing. A credit invoice method value-added tax (VAT) provides a widely used and accepted means by which the costs of domestic production can be insulated from tax effects. Such a tax, used by virtually every other industrialized nation, is collected at the border on imports, rebated on exports. Accordingly, SOCMA believes that the Congress should reject a BTU tax that cannot be border adjusted and turn to a credit method value added tax (VAT) as a source of new revenue that may be required, and as a replacement for much of the existing tax system.

SOCMA opposes energy taxes that fall heavily on the manufacturing process. An energy-intensive industry like the chemical industry that uses energy both as fuel and as raw materials for its production processes will be gravely wounded by unilaterally imposed energy taxes and be particularly hurt in world competition.

Chemicals is an energy-intensive industry. Its energy costs alone would rise by about $1.2 billion annually even with a feedstock exemption.

The chemical industry produces and sells in a highly competitive market. Margins on any given transaction are usually measured in cents per pound. After the 1980 enactment of the Superfund chemical feedstock taxes, U.S. chemical exports declined and imports increased sharply. However, after amendments in 1983 and in 1986 to provide border adjustments of the Superfund feedstock taxes, U.S. chemicals exports grew rapidly and by 1992 the chemical industry was the leading U.S. exporter.

Our industry was clearly harmed before Congress provided border adjustments for Superfund taxes. The proposed BTU tax on the energy used--even if limited to the energy used as fuel or power for our production processes--would be much more damaging to U.S. chemical trade than the Superfund tax. This is because the BTU tax would be much more costly. Furthermore, the energy tax costs embedded in finished products cannot be adjusted at the border under the General Agreement on Tariffs and Trade (GATT) or the U.S.-Canada Free Trade Agreement (CFTA).

Chemical industry trade performance has been a particularly important positive factor in the overall U.S. trade picture. For several years, chemicals has been the largest U.S. export sector. Exports of chemicals reached $44 billion in 1992, more than total U.S. agricultural exports. U.S. chemical trade surpluses in the ten years ending in 1992 totaled $122 billion. U.S. chemicals trade performance is not invulnerable, however.

Every developing nation wants its own chemical industry. Many developing countries are building their own production capacity. Some have their own low cost sources of energy. In the face of the resulting intensifying world competition the U.S. chemical trade surplus declined from $18.8 billion in 1991 to only $16.3 billion in 1992. Further slippage seems likely, even without the added burden of increased energy taxes and corporate income tax.

Some argue that an energy tax will increase energy efficiency. Chemical firms compete in the world economy. They do not need another tax to make them more competitive. Chemical firms are improving efficiency in every aspect of their production, <u>including</u> energy use. Our industry, for example, has improved its overall energy efficiency by 43 percent over the last two decades. Instead of spurring energy efficiency, a BTU tax would divert corporate funds that would otherwise be available for R&D or to invest in new, more efficient plant and equipment. A BTU tax would be an additional handicap on, and disincentive to, investment in U.S.-based manufacturing.

There is no valid way under the General Agreement on Tariffs and Trade (GATT) or the Canadian Free Trade Agreement (CFTA) to neutralize the harmful effects of an energy or environmental tax on U.S. trade. In effect, a BTU tax--and the increased income and other new taxes on U.S.-based production that are proposed in the President's plan--would penalize U.S. exports in world markets, encourage U.S. imports, and add to, not subtract from, the U.S. trade deficit.

The Administration's economic stimulus program should seek to maintain the competitiveness of U.S.-based manufacturers and the American jobs they provide. Increased U.S. tax rate changes will adversely affect manufacturing's international competitiveness. Since 1986, virtually all major trading nations have reduced their own corporate and business tax rates to at or near U.S. levels. Raising U.S. income tax rates under these circumstances would only increase the tax burden of U.S. exports in world markets and the corresponding tax advantage of imported products in the United States. Raising U.S. corporate income taxes is an invitation for more imports.

If Congress decides additional revenues are required, our trading partners, and competitors, around the world have demonstrated that a credit method value-added tax can produce needed revenue without imposing additional burdens on international trade. A credit method value-added tax is one of the few taxes valid under GATT that could increase U.S. saving and could increase the share of U.S. government costs borne by imported products.

SOCMA asks that the tax playing field applicable to U.S. industry not be tilted in favor of imports by the proposed energy tax. Instead, SOCMA asks that if spending reductions are not sufficient to cut the deficit and eliminate the need for an energy tax, the tax playing field be kept even or even made more favorable for U.S. manufacturers by adopting a credit method value-added tax.

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March 3, 1993

Majority Chief Counsel/Staff Director
Ways & Means Committee
U.S. House of Representatives
Washington, DC 20500

Dear Sir:

We people of Puerto Rico are concerned about the prevailing attitude in Congress concerning the 936 tax incentive given to Puerto Rico. The largest negative against the law is that the Pharmaceutical Companies enjoy a large mark-up on their product. These companies would have a large mark-up with or without the 936 incentive.

Puerto Rico needs incentives to have business come the distance to our island and if we lose these businesses they will go away from the United States to another country that offers them incentives to come to their country.

What we the people need in the United States and Puerto Rico are government policies that keeps work in our countries or states.

True wealth is only created with value added manufacturing to raw material. It is this Gross National Product that allows us to pay taxes and support our social programs.

We need government and business policies that allow us to work as partners in rebuilding the social structure that made our country great.

Together, who knows what we can achieve. Divided we will continue to flounder.

Sincerely,

Dave Knox
Vice President and
General Manager
Tech CBI, INC.

LAW OFFICES OF WALTER B. UDELL

1042 CAMP TRAIL ROAD
QUAKERTOWN, PA 18951-5018

PATENT, TRADEMARK AND COPYRIGHT MATTERS

TEL. 215-536-8607

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April 6, 1993

House Ways and Means Committee
1102 LHOB
U.S. House of Representatives
Washington, D.C. 20510

Attention: Staff Director Janice Mays
It will be appreciated if the enclosed copies of this letter are distributed to all Democrat members of the Committee for their consideration.
Thank you

Dear Representative:

This letter is writen to you as a member of the House Ways and Means Committee which will deal with the Budget Bill conference, to voice strenuous objection to the President's increase in taxes on Social Security benefits as presently proposed, because it is outrageously unfair in its present form. As presently structured, this tax change will cause the taxes of a retired couple having a taxable income of $53,000.00 (us) which includes total Social Security benefits of $21,000.00 (with no non-taxable sources of income) to suffer a forty five percent tax increase (45%).

This hardly comports with fairness when the proposed tax increase on persons having incomes of three times that amount is merely five percent (5%). Please understand that we are willing to pay our reasonable share of increased taxes, but this proposal is incredibly unfair. If it is enacted into law in its present form, President Clinton may well be a one term President. It will, without exageration, permanently alienate a large percentage of retired persons and convert many life-long Democrats to Republicans. It strikes at people who almost universally have no way of augmenting their income to offset or reduce the impact of the tax increase, and who have to deal with steadily rising costs such as real estate taxes. Even those few who might be able to do some part time work are slammed with a thirty three percent penalty on earnings over a meager $10,000.00 until they reach the age of seventy. Very few people at seventy are still in the work force.

My conclusions regarding the impact on my wife and me of the presently structured proposed tax change were arrived at by the following calculations.

CURRENT TAX

Pension and investment income of $32,000.00 taxed at 15%	= $4800.
Total Social Security of $21,000.00 X 50% taxed at 28%	= 2940.
Total federal tax on $53,000.00 of taxable income	= $6740.

PROPOSED NEW TAX

Pension and investment income of $32,000.00 taxed at 15%	= $4800.
Total Social Security of $21,000.00 X 85% taxed at 28%	= 4998.
Total federal tax on $53,000.00 of taxable income	= $9798.

PERCENTAGE INCREASE IN TAX

$$\frac{\text{NEW TAX - CURRENT TAX}}{\text{CURRENT TAX}} = \frac{9798. - 6740.}{6740.} = \frac{3058.}{6740.} = 45\%$$

This is an unconscionable tax increase when compared to the tax increases proposed for incomes many times higher. It is unconscionable because the people in the Administration who proposed it are not stupid. They are completely aware of the nature of this proposal and how it will impact on non-earning people of fixed income. It is at best cynical, and will not be lost on those voters who voted for Mr. Clinton, I among them, in the apparently terribly mistaken belief that he was being truthful in stating his intentions regarding tax fairness, particularly as impacting on the middle income population.

The only thing that could save this, in my opinion, would be to correct the indexing floor by raising the point at which the tax on Social Security benefits kicks in. Every year since 1983 when the 50% tax was initiated, people on Social Security have been paying a hidden increasing tax because of inflation. The colas were substantially wiped out by the fixed tax floor at $32,000. If the point at which the tax on Social Security begins had been indexed at an average annual inflation rate of three percent, the current tax floor would be somewhere in the $42,000 to $44,000 range.

The same kind of calculation as above given shows the following:
At a floor of $44,000, our tax would rise three percent.
At a floor of $42,000, our tax would rise ten percent.
At a floor of $40,000, our tax would rise seventeen percent.
Since $44,000. floor indexing would still result in a 3% tax increase, this would appear to be fair. However, we would be

willing to pay a somewhat higher tax, say somewhere in the range between the above shown ten and seventeen percent, but certainly not forty five percent!

Believe me when I say that implementation of the increased Social Security tax in its present form will be a political disaster for all elected Democrats who support it, for the simple reason that it will be an economic disaster for the people who have to pay it, and they will not forget from whence this came. Your support for the President's program is expected, but not blind, unthinking, let the people be damned arrogance.

Again, I repeat, no one that I know is unwilling to assume a fair share of the increased tax burden, but this present proposal is an outrage.

Sincerely,

Walter B. Udell

Walter B. Udell

STATEMENT OF THE UNITED STATES TELEPHONE ASSOCIATION

The following testimony is submitted on behalf of the United States Telephone Association ("USTA"). USTA is the primary trade association of local telephone companies, serving more than 99 percent of the access lines in the United States. USTA represents over 1100 members ranging in size from the regional Bell companies to the smallest of independents.

USTA supports the Clinton Administration's goals of deficit reduction and long-term economic growth. USTA supports the notion of spending cuts set forth in President Clinton's Economic Stimulus and Deficit Reduction Plan and hopes Congress will find significantly more. USTA also is pleased the Administration recognizes the critical role that capital investment, especially investment in the nation's technological infrastructure, must play in rebuilding our economy.

While USTA recognizes that deficit reduction and a balanced budget cannot be achieved totally through spending cuts, any tax increases must be fashioned in such a way as to enhance capital investment and job creation which are critical to achieving a sustained economic recovery. The Tax Reform Act of 1986 severely eroded our industry's internally generated funds available for telecommunications infrastructure development. The proposed 2% corporate rate increase will further erode those funds available for infrastructure development. The temporary incremental investment tax credit in its present form will not promote the technological investment essential for our nation's present and future competitiveness in the global economy. Furthermore, it certainly will not offset the long-term negative impact of the corporate rate increase.

A properly crafted investment tax credit mechanism, however, might achieve the stimulus sought by the Administration, and USTA stands prepared to work with this Committee to reach that goal. We would add that other, more targeted long-term incentives might be employed to focus on the technology infrastructure which the President's program is attempting to enhance. Again, we stand ready to assist this effort.

USTA continues to support legislation introduced again this year by Chairman Rostenkowski to simplify the tax treatment of acquired intangible assets. Enactment of this legislation, which was twice approved by Congress in 1992 and is now in H.R. 13, the Tax Simplification Act of 1993, would help restore U.S. international competitiveness in this area. Controversy and extensive litigation regarding the tax treatment of acquired intangible assets has consumed government and taxpayer resources better devoted to more productive endeavors and has created an uncertain investment climate. Enactment of this legislation would foster long-term economic growth by permitting taxpayers to employ scarce resources more productively and to make investment decisions which reflect a clear understanding of the tax treatment of acquired intangible assets without concern that lengthy and costly litigation may be required to resolve substantial conflicts between the taxpayer and the IRS.

A strengthened economy is essential for our industry's continued growth. The Administration's proposals clearly put the proper focus on improving our economy by dealing with the heavy burden of government debt and the consequent lack of investment in our future. What remains to be done is to implement proposals worthy of those ends. USTA would be pleased to join with the Committee as it approaches this task.

9417 White Sping Way
Columbia, MD 21046
March 29, 1993

Janice Mays, Chief Counsel and Staff Director
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Ms. Mays:

It is imperative to develop a program to produce a balanced budget in as short a time period as possible. Past efforts have been insufficient! To this end I propose the following three step program:
(1) First this year's budget must be frozen at last year's level with all items included, even debt service! This is best accomplished by passing the proposed Constitutional Amendment enclosed with this letter. The next two should be passed as enabling legislation.
(2) Second the deduction of interest on corporate debt should be eliminated except possibly for a tax deduction for research, development, and engineering of new products. This would raise a large amount of revenue and help reduce the overuse of debt in the corporate sector.
(3) Finally a social requirements fee should be imposed on all imports, at a minimum of three percent. It would be higher on goods from countries not agreeing to fair reciprocal trade, not following environmental regulations, not treating workers fairly or safely, not cooperating in mutual defense or other important areas. Companies benefiting from such a fee would have to freeze prices on domestically produced goods that compete. This would enhance our trade position as well as provide revenue.

Each dollar of revenue enhancement should be matched by one dollar of spending cuts. This total program should eliminate the deficit in about five years and the debt in twenty-five. Further deficits should only be allowed in a true national emergency as provided in the Amendment. I would like to submit this letter and the attached proposed amendment for inclusion in printed the record of the deficit reduction hearings.

Sincerely;

Eric W. Young, Ph.D.

PROPOSED AMENDMENT TO THE US CONSTITUTION

The total budgetary outlays(expenditures, loan guarantees, entitlements, etc.) for any subsequent fiscal year shall be less than or equal to the outlays for the year of ratification of this amendment. This limitation of outlays shall remain in effect until the deficit and total federal debt are eliminated. After such elimination this amendment shall require a balanced budget(outlays equal to revenue). The terms of this amendment may be temporarily waived, for a period not to exceed one year, in the case of clear and present national emergency. The declaration of such an emergency shall require a two-thirds vote of all members of both houses of Congress and agreement by the President. Enabling legislation shall be passed each year to enhance revenues and reduce outlays below this limitation.

TAXING GAINS AT DEATH

statement of Lawrence Zelenak,
Professor of Law,
University of North Carolina at Chapel Hill

When a person dies owning appreciated property, the appreciation is not subject to income tax at death, and section 1014 of the Internal Revenue Code gives the property a new basis, equal to the fair market value of the property at death. The result is permanent forgiveness of income tax on the appreciation. This result has been criticized for a number of reasons. It produces inequity between taxpayers who realize income during life, and those who transfer unrealized appreciation at death. The inequity is both horizontal (discriminating between different taxpayers of similar income and wealth) and vertical (favoring wealthy taxpayers because a greater portion of their income tends to be in the form of unrealized appreciation transferred at death). Current law is also objectionable for its lock-in effect: elderly taxpayers are discouraged from disposing of appreciated assets, because if they hold the assets until death, the appreciation will escape income taxation permanently. Finally, current law is costly to the fisc: the President's Budget for Fiscal Year 1993 estimates the revenue loss from not taxing gains at death at $28.4 billion for 1993. The Tax Reform Act of 1976 briefly reformed the taxation of appreciation transferred at death--not by taxing such appreciation at death, but by mandating a carryover basis for inherited property. However, this reform was retroactively repealed in 1980, in response to an intense lobbying effort. Much of the criticism of carryover basis focussed on its allegedly insuperable practical problems, including problems in determining decedents' asset bases. Since the 1980 repeal of carryover basis, the income tax treatment of appreciation transferred at death has remained unchanged.

I believe it is time for Congress to revisit this area, and to consider taxing gains at death. This offers an unusual opportunity to raise significant revenue without raising rates, and to improve the fairness and rationality of the income tax system in the process. In a forthcoming article in the March 1993 issue of the Vanderbilt Law Review, "Taxing Gains at Death," I consider in detail how Congress could design a death gains tax which would be fair and workable, and would raise substantial revenue. The major conclusions of the article are described below.

1. A death gains tax is preferable to carryover basis for several reasons. It is a much better solution to the problem of lock in. It eliminates the need to maintain basis records across generations. It does not involve the complication of increasing the basis of appreciated carryover basis property by the death transfer taxes attributable to the appreciation. It does not force executors to consider equitable distribution of basis as well as value among beneficiaries. It does not carry all the political baggage of carryover basis. Finally, taxing gains at death would raise several times more revenue than carryover basis.

2. There is a strong argument that transition relief for assets held as of the enactment of a death gains tax should be limited to those assets for which failure to keep adequate basis records is most forgivable--primarily nonbusiness tangible personal property (collectibles). If Congress decides, however, that taxation of pre-enactment appreciation is generally inappropriate, a bifurcated approach would work best to implement that decision. Publicly traded property should be given a basis equal to its fair market value as of the effective date of the new law, and other property should be given a basis determined by discounting back from the date of death to the effective date at a statutorily prescribed discount rate.

3. Many opponents of carryover basis argued that the difficulties of proving basis were so great as to make either carryover basis or tax at death impractical. I believe these

difficulties have been greatly overstated. With the possible exceptions of assets held when the new law is enacted (discussed above) and collectibles (discussed below), there would be no good excuse for a decedent's failure to have kept good basis records. It would be sensible, however, for the legislation to specify that the IRS and the courts must accept reasonable estimates of basis when perfect records are unavailable. Canada has taxed gains at death for over two decades, and Revenue Canada officials told me that proof of basis problems have not been significant. In fact, when I told them that alleged proof of basis problems played a leading role in the repeal of carryover basis, they found it hard to believe.

4. In light of the unlimited marital deduction in the estate and gift taxes, and the income tax nonrecognition rule for lifetime transfers between spouses (section 1041), there appears to be a consensus that transfers between spouses--either inter vivos or testamentary--are not appropriate occasions for the imposition of tax. In line with this consensus, a spousal bequest of appreciated property should be subject to a carryover basis rule, rather than to immediate imposition of tax. This would create some administrative problems, because the amount of appreciation subject to death gains tax would be uncertain until property had actually been distributed to the surviving spouse (or at least identified as destined for distribution). It should be possible, however, to provide for a return date late enough that distribution by the due date is practical. Another possible approach would be to permit returns to claim tentative exemptions for assets that the executor reasonably anticipates eventually will be distributed to the surviving spouse. If the actual distribution differs from that anticipated by the return, an amended return would be required. This technique--of allowing returns to be filed in anticipation of an act qualifying a gain for nonrecognition--is already in use with respect to involuntary conversions and replacements of personal residences.

5. If a taxpayer pays a capital gains tax during life, the tax paid depletes his potential taxable estate. In order for a capital gains tax at death to have an equivalent effect on estate tax liability, the capital gains tax should be deductible in computing the taxable estate. It would not be necessary to amend the estate tax to achieve that result, since section 2053(a)(3) already provides a deduction for "claims against the estate." Some commentators have argued, however, that any death gains tax should not be deductible, because allowing a deduction would have a regressive effect. The claimed regressive effect is based on the fact that any given dollar amount of deductible gains tax liability is more valuable to an estate in a higher estate tax bracket than to an estate in a lower bracket. The alternative to a deductible gains tax would be a flat rate tax on appreciation held at death, imposed at a low rate to compensate for its nondeductibility. But the argument that a deductible gains tax is regressive is fundamentally misguided. The argument is based on a misunderstanding of Stanley Surrey's insight that tax expenditures in the form of deductions are "upside down subsidies." Surrey's point applies, however, only when the deduction functions as a subsidy. When the deduction is not a subsidey, but rather an integral part of the logical structure of the tax base, the criticism makes no sense. The estate tax deductibility of gains tax liability <u>is</u> a basic part of the structure of the estate tax base: the tax base is wealth gratuitously transferred at death, and wealth that must be used to pay gains tax cannot be so transferred.

6. There should be an exemption from a death gains tax for small estates. At some point, estates are small enough that the revenue gained from taxing their appreciation does not justify imposing the complexities of a death gains tax. The difficult question is finding that point. The best answer is to design the exemption to track (so far as possible) the estate tax exemption provided by the unified credit, so that estates not subject to the estate tax also would not be subject to the gains tax. This could be done by giving every estate a minimum basis of $600,000 (or

whatever the estate tax exemption level happens to be).

7. To prevent easy avoidance of the death gains tax by gifts during life, appreciation must be taxed on gifts as well as bequests. The minimum basis allowance should be available for gifts. Allowing any minimum basis for gifts, at a time when the total actual basis of gifts and bequests is unknowable, creates the possibility of allowing an inappropriate basis increase--inappropriate becasue the total actual basis of all gifts and bequests ultimately may exceed the minimum basis amount. There is, however, a simple solution to this problem: allow the minimum basis adjustment for gifts, but reduce the basis of assets transferred at death to the extent that the previously allowed adjustment was excessive, viewed with the benefit of hindsight.

8. Nonbusiness tangible personal property (TPP) presents special administrative problems for a death gains tax. Such assets tend to be numerous and of relatively low value. Moreover, these are the assets for which adequate basis records most likely do not exist. The best solution is to provide each gratuitously transferred (by gift or bequest) TPP item a substantial minimum basis for purposes of computing gain. There is, of course, no magic number for what the minimum basis amount should be, but $5,000 per item seems about right.

9. The strict limitations on the deductibility of capital losses are based on concerns about selective realization of losses. If the law mandates the realization at death of <u>all</u> capital gains and losses, then selective realization of losses at death is not a problem, and the ordinary limits on the deductibility of capital losses should not apply. There is some opportunity for selective realization of losses at death if gain assets are left to a surviving spouse and loss assets are left to other beneficiaries. However, the opportunity is sufficiently limited that generous rules for the deductibility of losses should probably apply even in that situation.

10. In some cases (but not most), a death gains tax would impose significant liquidity problems. These problems are not different in kind, however, from those already imposed by the estate tax. Whatever liquidity relief Congress deems appropriate for estate tax liability should also apply to the gains tax. The introduction of a death gains tax would be an appropriate occasion for Congress to reexamine the adequacy of the liquidity relief provisions of current law.

Considering the amount of attention that has been given to base-broadening tax reform options since the mid-1980's, the virtual absence of consideration of reforming the treatment of gains at death has been disappointing. The brief and unhappy life of carryover basis may be the explanation for the lack of recent interest in this area. But well over a decade has passed since the repeal of carryover basis, and it is time for Congress to revisit the area. When it does so, it will find that taxing gains at death is a more attractive option than carryover basis. It also will find that, although there are difficult choices to be made among simplicity, fairness, and revenue concerns, it is possible to design a death gains tax that is workable, fair, and raises substantial revenue. Consideration of such a tax should be high on Congress's tax agenda.

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